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How Significant and Effective Has Foreign Aid to Indonesia Been?

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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 throughout the 1970s and 1980s. However, no systematic study has been done so far on the effectiveness of foreign aid in Indonesia. This paper, thus, attempts to examine the historical significance and effectiveness of aid flows to Indonesia. The correlation between aid and economic growth was found to be positive, but low. However, aid flows were crucial for maintaining development and social expenditure, especially at times of crises. In addition, aid flows smoothed out balance of payments problems and played an important catalyst for policy reforms; but there were also evidence of reversing reforms. The certainty of aid flows helped the government to follow the balanced budget principle, but made the government lazy in terms of domestic resource mobilization. As a result, despite significant progress, Indonesia's external debt burden remains high, and it has little ability to handle crisis without substantial foreign aid. Because of a weak domestic revenue base, the uncertainty regarding fiscal sustainability remains unresolved.

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 the allocation of aid to those countries with records of "good" policies and are 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 (Odedokun 2004, p. 229). Easterly (2003, p. 38) has expressed doubts about the effectiveness of selectivity in aid allocation. He has characterized 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 of 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, emphasized 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. It is widely believed that foreign assistance played a significant role in Indonesia's success in terms of sustaining rapid growth for three decades until it was hit by the crisis in the late 1990s. Starting as an International Development Association (IDA) recipient in the late 1960s, Indonesia graduated to an International Bank for Reconstruction and Development (IBRD) client, and the bulk of its foreign financing since the early 1990s until the crisis was from commercial sources.[5] 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 headcount ratio of poverty) for every percentage point increase in the growth rate (Mishra 1997).

However, as noted by Hill, there has been no serious systematic study of the effectiveness of aid to Indonesia. 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.

On the other hand, the cosy relationship between the Soeharto government and the donor community, and the revelation of widespread 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.

In the context of the above, this paper examines the contribution of foreign aid to Indonesia's transformation by looking at a number of indicators such as development expenditure and balance of payments. It also evaluates the influence of foreign aid on policy reforms and the government's expenditure behaviour and revenue efforts as well as the possible linkage between aid and corruption. The paper is organized as follows. Section II provides a 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 the 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 fraternizing with the communist countries, the New Order firmly allied 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 very 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]

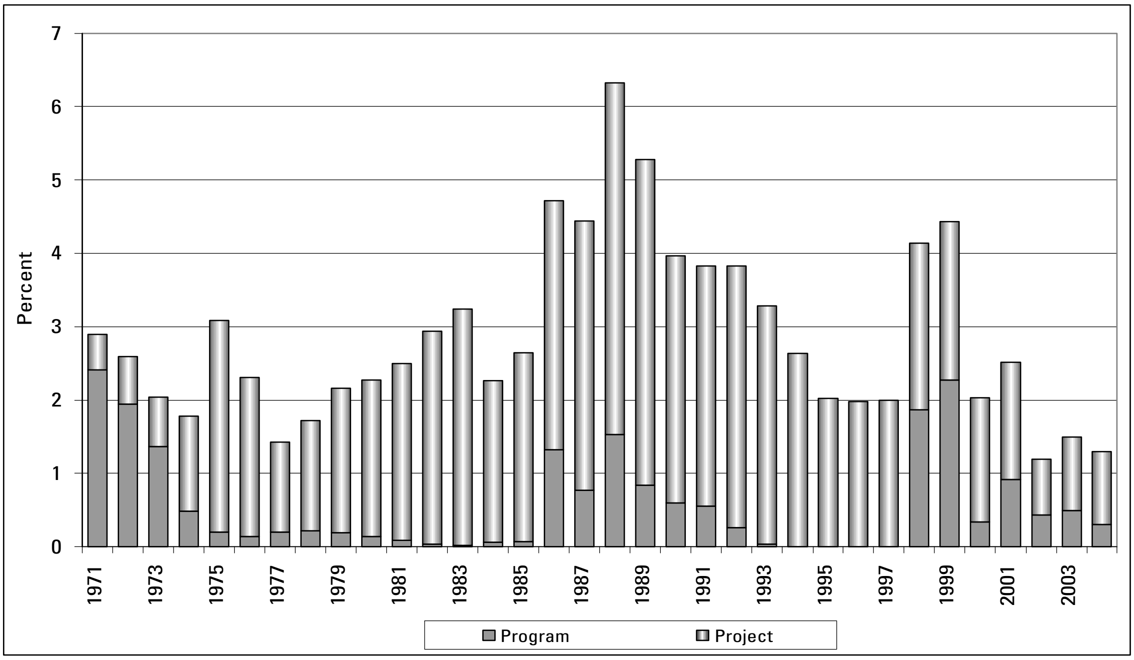
However, the inclusion of some structural reform measures in the conditionality of the International Monetary Fund (IMF) following the latest economic crisis caused strain in the relationship with the crumbling New Order regime and subsequent governments since its demise.[8] Although the relationship improved markedly since the installation of President Megawati'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.

II.1. 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 per cent of GDP as the economy began to show signs of improvement in the early 1970s. It dropped to about 1.5 per cent of GDP in 1977, but since then continued to rise until 1988, peaking at roughly 6.5 per cent 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 per cent of total government revenue in 1981 to about 30 per cent in 1988–89. Since then official aid flows continued to decline as private capital inflows surged in the early 1990s.

Of course the situation has changed markedly since the economic crisis of 1997–98. Gross foreign aid flows rose from 2 per cent in 1996–97 to about 4.5 per cent of GDP in 1999. 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 the balance of payments. It is not recorded in the state budget, but goes to the Bank

FIGURE 1
Aid Flows as Percentage of GDP, 1971–2004



NOTE: Budget figure for 2004.
SOURCE: *Financial Memorandum* (Nota Keuangan), Ministry of Finance (MOF), various years. The data exclude capital transaction with the IMF.

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 per cent. Thus, the economic crisis and the consequent ballooning of government debts (both domestic[10] and external) have turned Indonesia into one of the most aid-dependent countries in the region (Table 1). In 1998–99, Indonesia's 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 had stabilized. In 2004, the aid-GDP ratio stood at slightly over 1 per cent, a figure much less than what it was in the early 1990s.

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 per cent of government revenue to close to 12 per cent in 1997, foreign aid rose to about 28 per cent of government revenue in 1998. From its post-crisis peak, aid-revenue ratio declined to about 8 per cent in 2004.

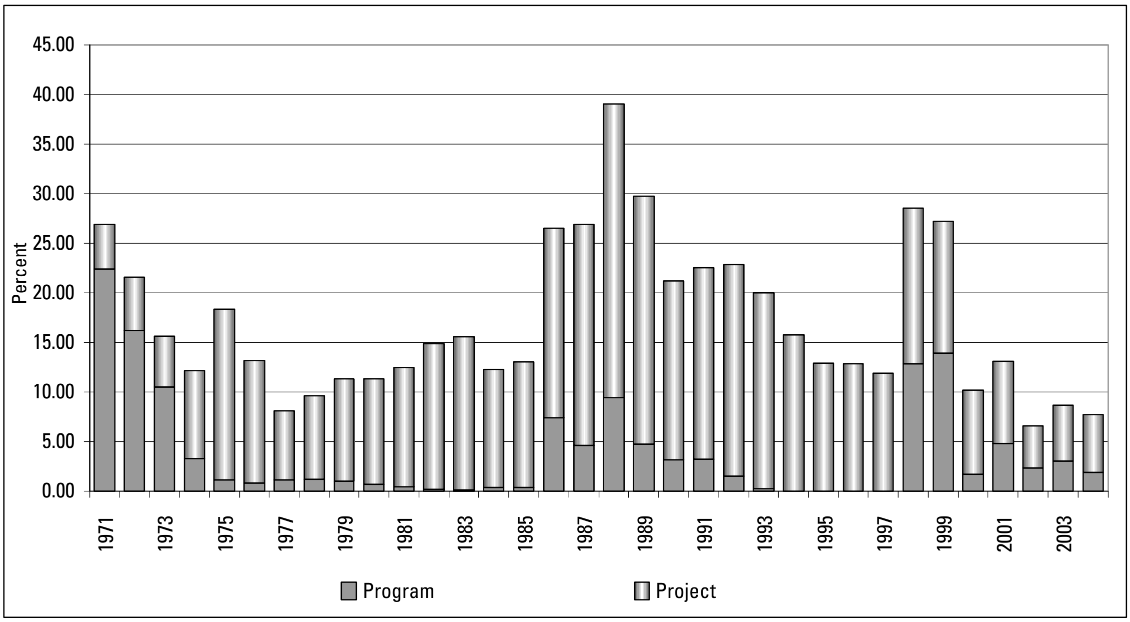
Perhaps the most telling indicator of the significance of foreign aid is its share in total development expenditure. As can be seen from Figure 3, foreign aid financed nearly 70 per cent of total development expenditure in 1971, dropping to about 22 per cent in 1974 as a result of oil bonanza. It fluctuated between 20 and 30 per

TABLE 1
Official Flows from All Sources to Selected Countries, 1990–2002
(Percentage of GDP)

Country	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
Indonesia	2.68	3.09	2.75	1.89	1.30	0.93	–0.08	0.51	3.44	2.96	1.63	0.90	0.18
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	–3.07
Philippines	3.47	3.13	4.02	3.10	1.24	–0.13	0.63	0.67	0.67	0.48	0.23	0.20	0.45
Vietnam	1.66	2.38	5.22	1.18	4.53	3.06	2.50	3.13	5.60	4.55	4.63	4.55	3.36
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	2.07
Pakistan	4.40	4.69	3.80	3.46	3.30	2.43	2.71	1.95	2.07	2.10	1.20	3.48	1.74
Sri Lanka	7.98	9.70	4.78	5.58	4.60	4.75	4.45	3.82	4.05	2.54	2.37	2.28	2.53

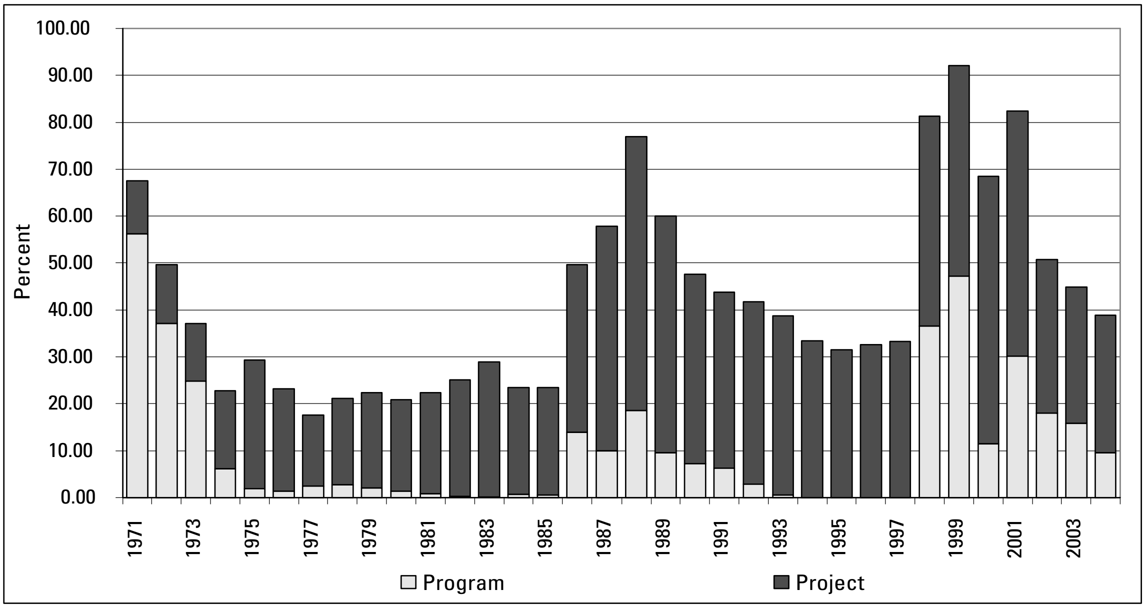
SOURCE: ADB, Key Indicators (www.adb.org).

FIGURE 2
Aid as Percentage of Domestic Revenue, 1971–2004



NOTE: Budget figure for 2004.
SOURCE: *Financial Memorandum*, MOF, various years.

FIGURE 3
Aid as Percentage of Development Expenditure, 1971–2004



NOTE: Budget figure for 2004.
SOURCE: *Financial Memorandum*, MOF, various years.

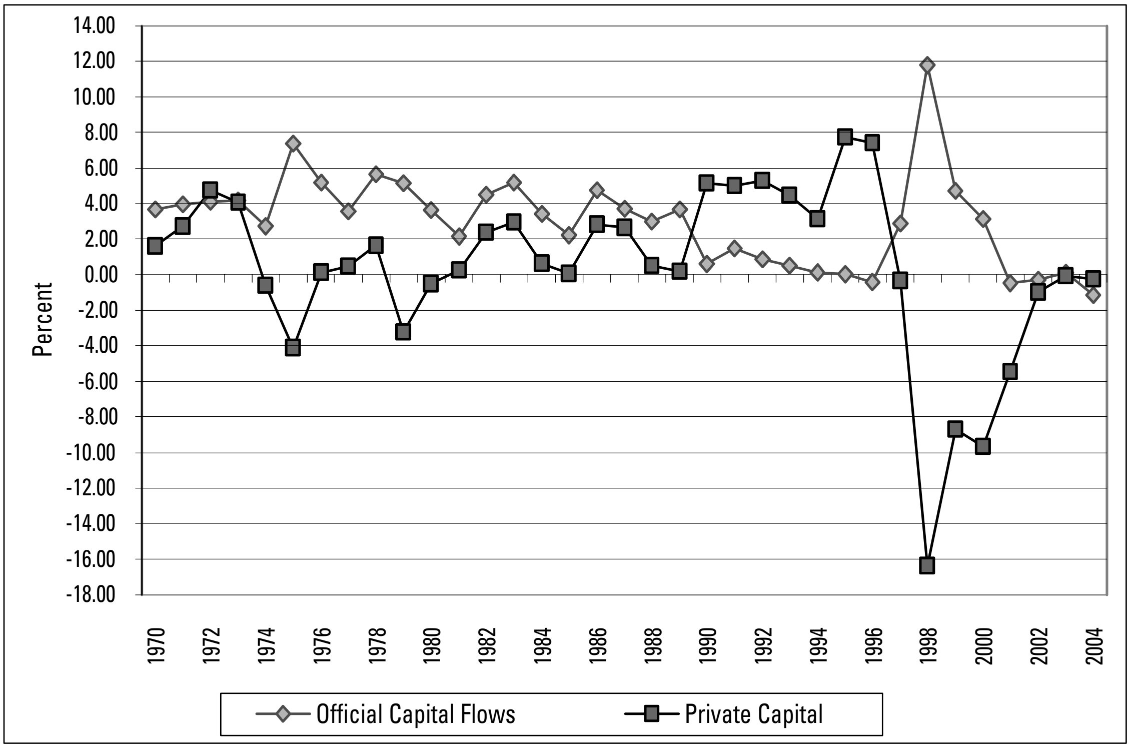
cent during the period 1975–85. The contribution of foreign aid to development expenditure rose to about 78 per cent in 1988 when aid flows peaked at 6.5 per cent of GDP (Figure 1). But after the crisis during 1998 and 2001, over 80 per cent of development expenditure was financed through foreign aid. Thus, Indonesia's scale of post-crisis aid-dependence resembles that of late 1969 at the start of the New Order regime.[11]

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

II.2. Sources and Sectoral Distribution

Indonesia has received official development assistance (ODA) from thirteen multilateral agencies and twenty countries in the past. The World Bank and the Asian Development Bank (ADB) are the two major multilateral donors. Among the bilateral donors, Japan is by far the largest, accounting for nearly 70 per cent of total bilateral pledge. The IMF is not a donor agency and hence is not a member of the Consultative Group for Indonesia (CGI), although its programs

FIGURE 4A
Net Official and Private Capital Inflow as Percentage of GDP, 1970–2004



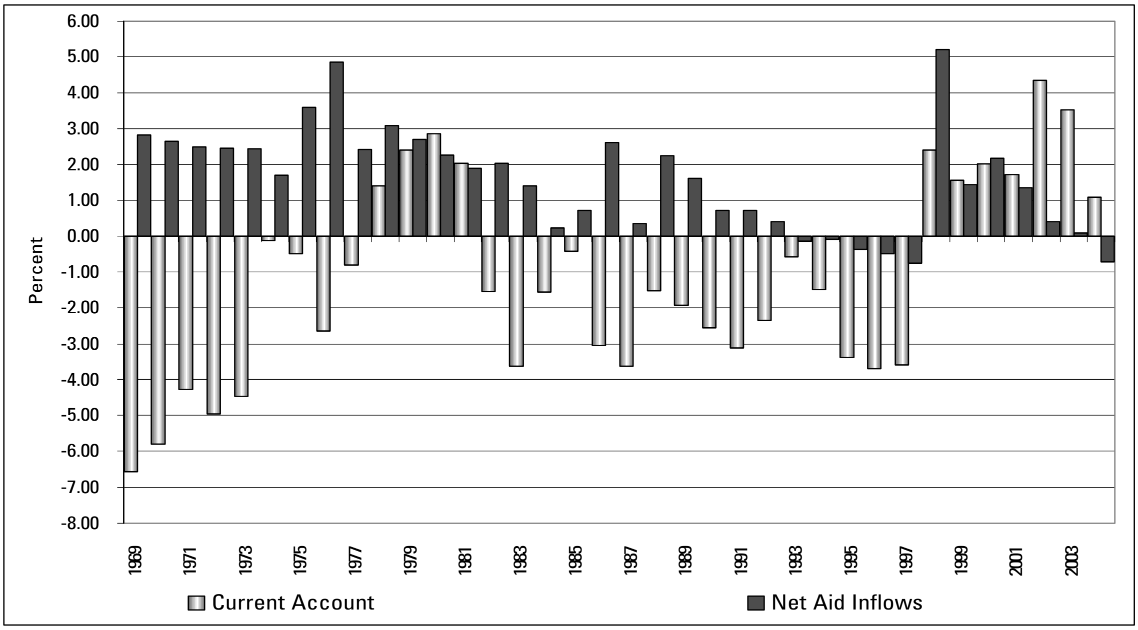
NOTES: Official = ODA + IMF; Private = FDI + Short-term.
SOURCE: *International Financial Statistics*, IMF database (CD-ROM).

have implications for other donors and the overall aid flows.[12]

As can be seen from Table 2, the sectoral distribution of aid in Indonesia changed over time. In FY 1990/91–1995/96, the five largest aid recipients were the mining, transportation, agriculture, education, and national defence sectors.[13] In FY 1996/97, just before the crisis the main recipients were the mining, transport, irrigation, telecommunication, 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 per cent to less than 10 per cent. 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 decentralization process that Indonesia undertook in 2001 following the crisis.

There have also been significant increases in aid allocated to national defence since 2003. Its share of aid doubled from about 7.7 per cent in 2001, 15.5 per cent in 2003, and rose to 23.7 per cent in 2004. This reflects the growing importance the donor countries are giving to Indonesia due to security factors that arose after the 11 September 2001 event. On the other hand, despite concerns

FIGURE 4B
Current Account Deficit and Net Aid Flows as Percentage of GDP, 1970–2004



NOTES: Official = ODA + IMF; Private = FDI + Short-term.
SOURCE: *International Financial Statistics*, IMF database (CD-ROM).

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 funds may have contributed to the slow progress in reforms in these areas. It might as well be the case that the donors were reluctant to channel funds to these areas, as the government was unable to achieve much progress in reforming these institutions.

II.3. Composition and Terms

Foreign aid is classified as technical assistance (TA), grants, and ODA. ODA is basically a loan and is provided on a concessional or commercial basis. For nearly two decades prior to the crisis, Indonesia did not receive development assistance from the IDA, the World Bank facility for highly concessional loans to low-income countries, as by the mid-1980s it had become a low middle-income country. Only after the economic crisis, the World Bank approved US$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 programmes.

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 per cent compared to more than 60 per cent 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

TABLE 2
Sectoral Distribution of Project Aid
(In Percentages)

Sector	*1990/ 91*	*1995/ 96*	*1996/ 97*	*1998/ 99*	*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 Co-operative	3.82	3.23	1.77	2.63	0.98	1.01	0.51	0.01	0.00	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. and 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	0.00	0.00
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

NOTES: *Budget figures. Fiscal Year until 1999 was from June to July. Since 2000, it is from January to December.
SOURCE: *Financial Memorandum*, MOF, various years.

TABLE 3
Average Terms of Aid, 1970–2002

Terms	*1970*	*1980*	*1990*	*1995*	*1997*	*1999*	*2000*	*2001*	*2002*
Interest (%)	2.4	5.4	5.6	5.1	6.3	3.8	4.2	4.8	3.7
Maturity (years)	35.9	25.5	23.1	21.3	19.5	16.7	19.0	22.7	21.7
Grace period (years)	9.5	7.3	6.6	5.8	4.9	5.1	6.7	5.6	5.9
Grant element (%)	62.9	36.2	32.8	33.3	22.7	38.1	40.9	36.6	41.8

SOURCE: World Bank (2004), *Global Development Finance*.

crisis, but nowhere near what Indonesia enjoyed in 1970.

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 IMF 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 per cent of GDP, and only a tiny 0.5 per cent 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 US$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 multilateral assistance. Tables 4A and 4B list the IMF and World Bank stabilization 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 World Bank 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.[14]

II.4. 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 SDR8.3 billion, but only SDR3.7 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 recognized that the crisis would not end very soon. The first EFF was expected to expire in February 2000, and it involved an SDR5.4 billion. The program imposed structural measures which emphasized bank and corporate restructuring on top of the usual fiscal and monetary measures.

As the end of the crisis was hardly in sight, the second EFF was signed in February 2000 to end in December 2003. This involved an SDR3.6 billion loan commitment from the Fund. In addition to bank restructuring, the EFF also introduced new measures (decentralization) and strengthened measures on privatization and legal reforms.

There has been considerable confusion about the purpose of and need for loans from the IMF. The IMF money is commonly perceived as a form of "bailout", 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 United States, Japan, Australia, China, Hong Kong, and Malaysia. The financial scheme totalled

TABLE 4A
The IMF Stabilization Loans to Indonesia

Program Type	*Date of Approval*	*Expiry*	*Amount Approved*	*Amount Drawn (Disbursement ratio %)*
Stand-by Arrangement	March 1972	1973	US$14 million	
CFF	August 1983		SDR360 million	
CFF	7 May 1987			SDR463 million
Stand-by Arrangement	5 November 1997	25 August 1998	SDR8.34 billion	SDR3.67 billion (44.0%)
EFF	25 August 1998	4 February 2000	SDR5.38 billion	SDR3.79 billion (70.6%)
EFF	4 February 2000	31 December 2003	SDR3.64 billion	SDR1.99 billion (54.6%)

NOTE: Indonesia did not renew its program with the IMF after the expiry of Extended Fund Facility (EFF) in December 2003.
SOURCE: IMF website (www.imf.org).

TABLE 4B
The World Bank Adjustment Loans to Indonesia

Type	*Date of Approval*	*Amount Approved*
Trade Policy Adjustment	1987	US$300 million
Policy Reform Support	1999, 2000	US$1.5 billion
Social Safety Net Adjustment	1999	US$600 million
Water Resources Sector Adjustment	1999	US$300 million
Policy Development	2004	US$300 million

SOURCE: BAPPENAS database.

to US$43 billion and grouped into two lines; US$23 billion in the first line and US$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 has never been utilized.

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 US$24 billion.[15] 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 a 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.[16] Therefore, the additional reserves were not necessary, and practically speaking, Indonesia was capable of returning all IMF loans before the termination of the program.

TABLE 5
International Financial Rescue Package for Indonesia

Contributors	*Amount (US$ 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

SOURCE: IMF announcement as quoted by the *Jakarta Post* and other media (7 November 1997).

While Indonesia did not need to use the IMF money, it still ended up bearing the cost. For example, in 2002 Indonesia paid US$2.3 billion to the IMF, consisting of US$1.8 billion in principal and US$500 million in interest payment (Ramli 2002, p. 13). On average the cost of this *idle* fund (fees and interest) was about 3.5 percent.[17] Table 6 presents a breakdown of repayments to the IMF.

Furthermore, program loans from the World Bank and the ADB can be obtained without IMF involvement. This means that commitments from other donors can be made without tying it to IMF conditionality.[18] The reason for the inclusion of other donors' commitment in the first rescue package was to prop up market confidence by showing that, collectively, donors stood ready to help Indonesia financially with a large amount of money (US$43 billion). But this was not effective at all — instead of building confidence, it might have ruined it. A large amount of financial schemes might have created a perception that the problems that Indonesia faced were actually worse than the market expected. Thus, the effectiveness of the IMF rescue package and conditionality of its program generated passionate debates among Indonesian policy-makers and practitioners.[19] 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

TABLE 6
Disbursement and Repayment of IMF Loans
(In SDR)

Year	*Disbursements*	*Repayments*	*Interest*
2004	0	678,074,998	172,252,204
2003	1,376,240,000	979,256,666	148,635,100
2002	1,100,960,000	1,834,560,000	202,864,442
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

SOURCE: IMF (www.imf.org), all are December figures.

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 that aid is only one factor, and a host of other institutional and behaviourial factors are responsible for economic growth.[20] Yet it is useful to begin with a look at the aid-growth relationship.

III.1. Aid and Growth

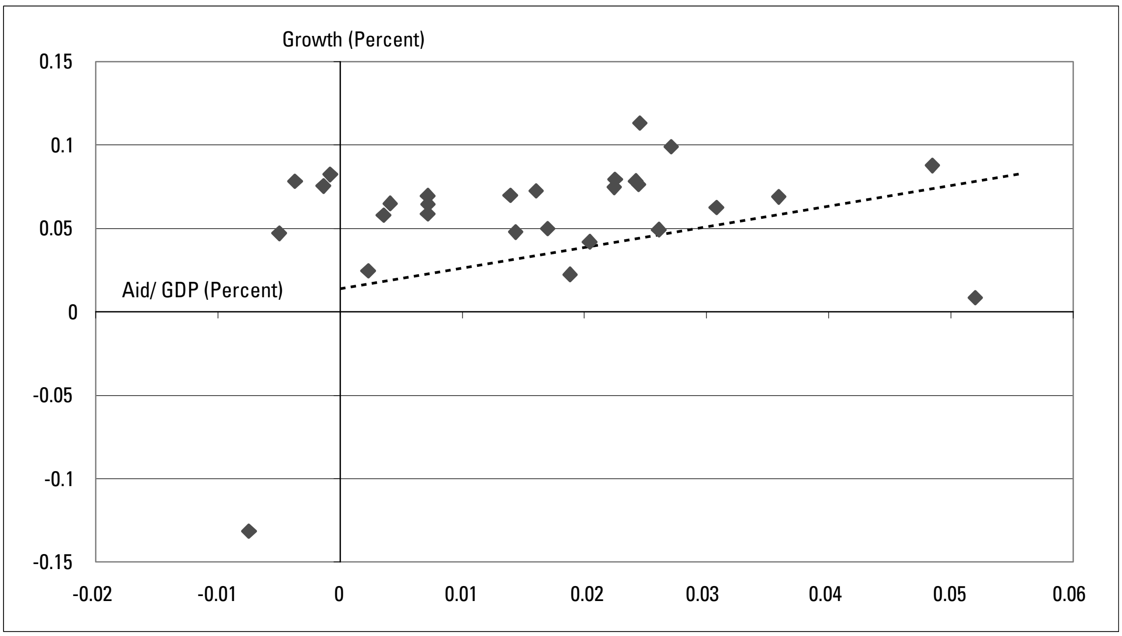
Figure 5 shows that there is a positive relationship between aid flows and economic growth in Indonesia. A correlation coefficient of 0.25 may be regarded as too low to conclude that aid has been very effective. However, foreign aid's contribution can be much larger when one considers aid's influence on other growth augmenting factors, such as macroeconomic stability and policy reforms. On the other hand, aid effectiveness can be adversely affected by corruption, misuse, and misallocation.

Therefore, the assessment of aid effectiveness should be examined from other perspectives beyond the simple aid-growth relationship.[21] They include contributions to: (a) policy reforms, (b) macroeconomic stability by supporting budget and current account deficits, and (c) development and social sector expenditure. The discussion will also reflect on the issue of tied aid, the link between aid and corruption, and aid's impact on government's expenditure behaviour and revenue efforts.

III.2. 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 liberalized its capital account completely in the early 1970s, and

FIGURE 5
GDP Growth Rate and Aid/GDP Ratio, 1972–99



SOURCE: *Financial Memorandum*, MOF, various years.

its foreign investment policy was hailed as a model for others. Since the mid-1980s, Indonesia initiated a major deregulation of the financial sector and trade liberalization. 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 the 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 suffer 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.[22]

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 liberalized once again only in 1992 when 100 per cent foreign ownership was permitted.[23] 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 towards 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 in the wake of economic crisis.

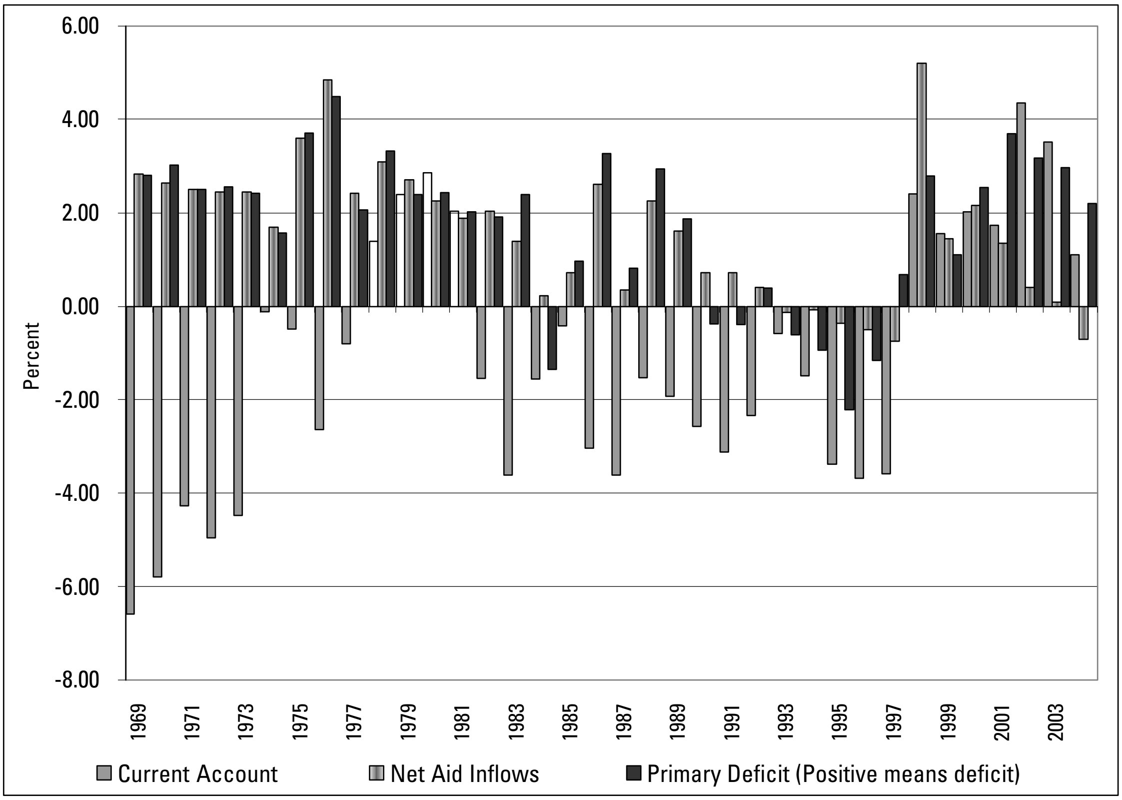
III.3. Aid and Macroeconomic Stability: Balance of Payments and Budget Support

In the 1970s and 1980s, current account deficits largely reflected the size of government budget deficits (Figure 6). Budget deficits were mostly financed with foreign borrowings. Over the period 1982–96, 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 the government's, in the ultimate analysis, accumulated past budget deficits were responsible for the persistent current account deficit during the later period.

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 6, the fluctuations in aid flows almost mirrored the size of government budget deficits. Econometric tests show that foreign aid is demand driven, and budget

FIGURE 6
Budget Deficit, Current Account Deficit, and Net Aid Flows as Percentage of GDP, 1969–2004



SOURCES: *Financial Memorandum*, MOF, various years, and *Indonesia Balance of Payments*, Bank Indonesia, various years.

deficits cause foreign aid.[24] 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 modernize 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 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.[25]

Second, financing the deficit through the commercial domestic market was difficult in an underdeveloped financial market. The domestic bond market was very thin and therefore could not be relied on for deficit financing.[26] Before the crisis, the size of the market was only about 6 trillion rupiah. After the crisis, although the government has issued bonds amounting to 660 trillion rupiah as a result of bank bailout, only about 10 per cent 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 a 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.[27]

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 the late 1960s and 1970s. The runaway 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 "balanced 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 the adverse effects of a 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.

Fifth, obtaining concessionary loans from bilateral and multilateral donors can reduce financial cost. Government projects are typically less commercially oriented than private projects, 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 more favourable; lower interest rate and a longer repayment period. For instance, in 2002, the average interest rate of official creditors was only about 3.7 per cent per annum, with average maturity of about 21.7 years, grace period of about 5.9 years, and the grant element of the total aid was about 41.8 per cent (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 downturn, 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 per cent 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) argue that impact of aid on growth rises significantly if external shocks are taken into account. They 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 4A), 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 summarized 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.[28] As mentioned earlier, Indonesia's net aid flows mirrored government's budget deficit (Figure 6). Simulations indicate that both program and project aid induces increases in routine expenditure and declines in non-oil tax revenue.[29] 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 puts less effort to collect tax because the creditors stand ready to fill the gap between government revenue and expenditure.

III.4. 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 per cent, 80 per cent, and 90 per cent 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 per cent during 1971–85, and it rose to 48 per cent during 1986–96 and stands at around 67 per cent 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 transport sector continued to receive close to 20 per cent of ODA, which also aided the development of the tradable sector. Thus, aid perhaps was not "immiserising".[30]

However, the social sectors health, education, and public housing received 2 per cent to 6 per cent of aid money. Therefore, if expenditure on the 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, Ranis, and Stewart (1997) show that countries that focus on growth alone perform relatively poorly with respect to both growth and human development indicators. On the other hand, countries which emphasize investments in human development also reap benefits of higher growth. Based on cross-country evidence Mosley, Hudson, and Verschoor (2004) find a significant relationship between poverty (headcount ratio) reduction and pro-poor public expenditure.[31] They also report a 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 23 per cent in 1997/98 to 10 per cent in 1998/99, but real health expenditure could be maintained due to a 17 per cent increase in donor assistance in real terms in 1999/2000.

III.5. 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 per cent of aid goes back to donors in the form of purchases of goods and services (consultancy). As can be seen from Table 7, on average close to 80 per cent of aid money goes back to bilateral donor countries. The proportion is around 60 per cent for the ADB. Aid tying raises the issue of who gets the most benefit from aid flows.

III.6. Aid and Corruption

Given a reasonably high domestic savings ratio (close to 30 per cent 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 in a very high incremental capital-output ratio (around 5 for a growth rate of approximately 6 per cent), implying a massive inefficiency in the use of capital. Besides low productivity, this could be due to misuse of investment funds. Indeed, corruption has been identified as a 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.[32] 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 minimize bureaucratic controls and pursue their own objectives. But it also meant a lack of instruments for proper monitoring leading to a lack of accountability 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.[33] 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 government and donors to audit the past use of loans as demanded by some civil society organizations.

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

TABLE 7
Tied Aid as Percentage of Total

Creditors	*Foreign Utilization (%)*	*Local Utilization (%)*
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

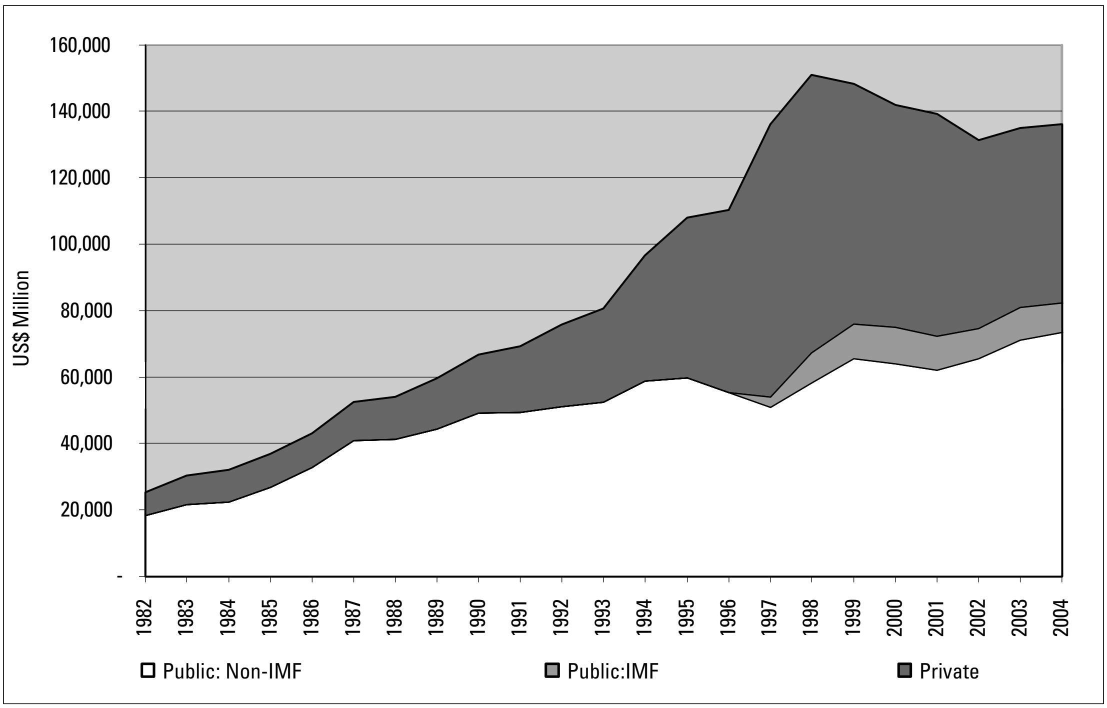
SOURCE: Internal estimates by BAPPENAS based on sampling of various project aid disbursed between 1999 and 2001.

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 ODA. 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

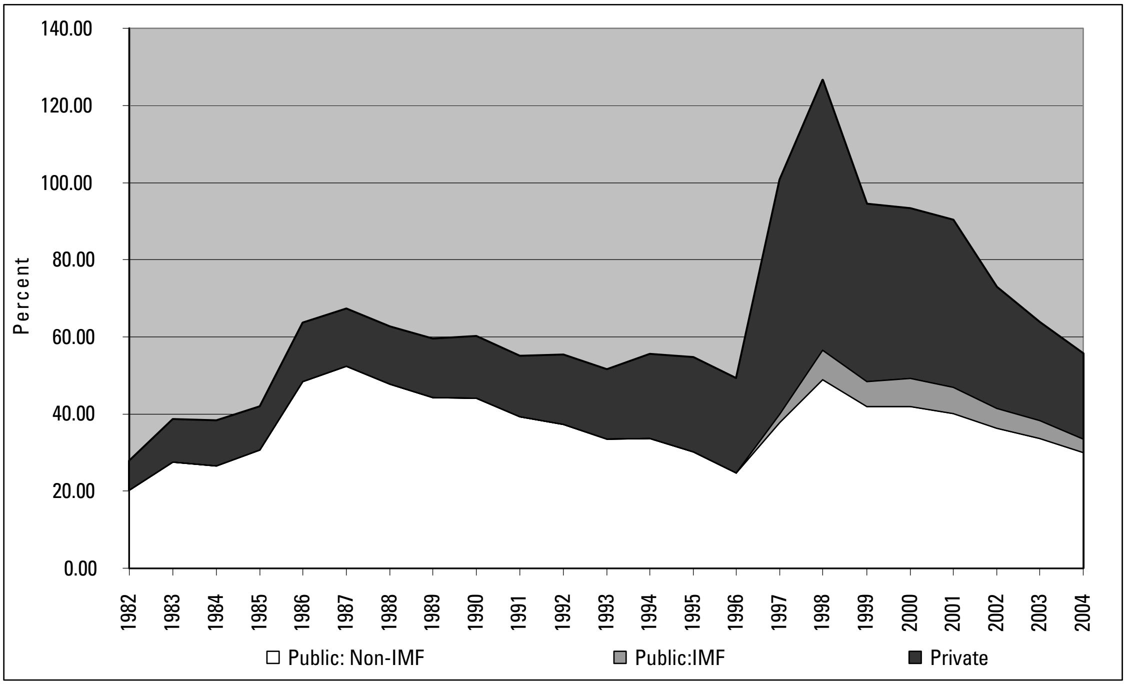
The most debilitating post-crisis issue is the burden of external debt and its impact on the state budget.[34] The public external debt increased from US$54 billion in 1997 to about US$80 billion in 2003 (Figure 7A). The external public debt as a percentage of GDP has been steadily declining since its peak of about 50 per cent in 1987 to about 26 per cent in 1996. It jumped to about 45 per cent in 1997 in the wake of the crisis and continued to rise to reach about 55 per cent of GDP in 2000–01. The public external debt in 2004 stood at around 39 per cent of GDP (Figure 7B).

FIGURE 7A
Trend in Foreign Debt, 1982–2004
(In US$ million)



SOURCE: *Financial Memorandum*, MOF, various years.

FIGURE 7B
External Debt as Percentage of GDP, 1982–2004



SOURCE: *Financial Memorandum,* MOF, various years.

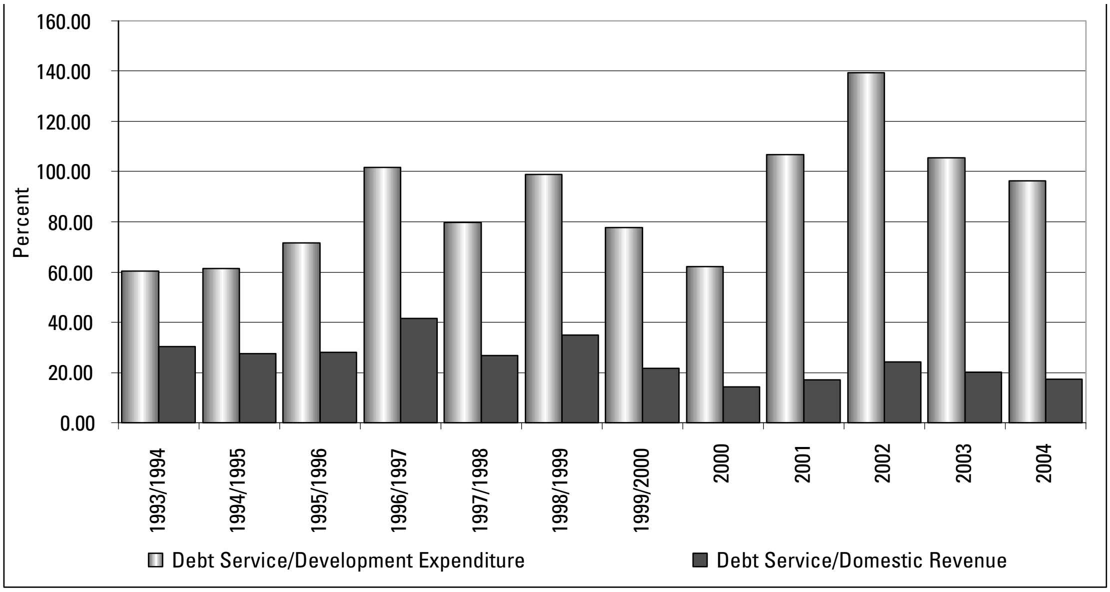
The overall external debt remains at over 60 per cent of GDP which is more than twice the projected size in the medium-term economic framework (Propenas 2000–04).[35]

More than a half of the increase mainly reflected the net borrowing from the IMF which was about US$10 billion in 2001. Without the loan from the Fund, the public external debt should be about US$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 six months 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.

IV.1. Debt Servicing and Development Expenditure

External dependence and debt burden is not an entirely new phenomenon for Indonesia. As can be seen from Figure 8, about 40 per cent of domestic revenue was spent in servicing external debt even in 1996/97 prior to the crisis. This happened as debt incurred in the mid-1980s fell due. As noted earlier, foreign aid financed nearly 80 per cent 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 per cent in 1997 to over 90 per cent in 1999.[36] Yet more is spent on external debt servicing than on development. The ratio of external debt service

FIGURE 8
Public Foreign Debt Service as Percentage of
Development Expenditure and Domestic Revenue, 1993–2004



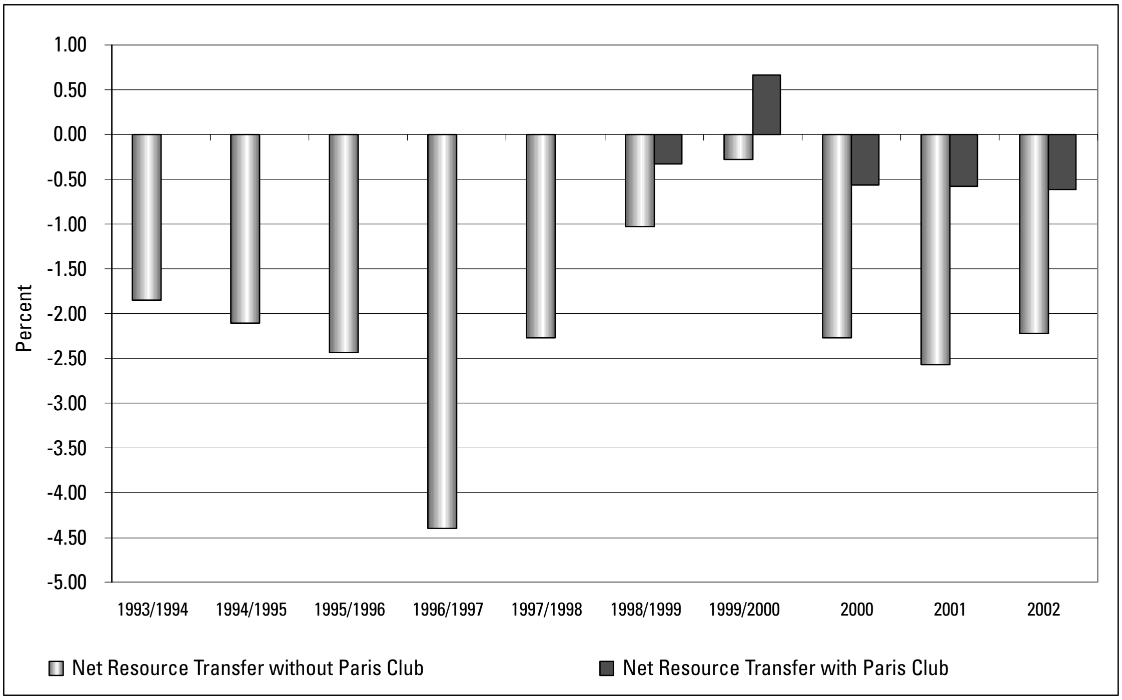
Source: Financial Memorandum, MOF, various years.
SOURCE: *Financial Memorandum*, MOF, various years.

(excluding the servicing of IMF loans) to development expenditure stood at 140 per cent in 2002. If the servicing of IMF loans were taken into account, this figure would be much higher. Thus, debt servicing is putting a huge pressure on the capacity of the state to finance social expenditure.

Historically, external debt servicing as a proportion of development expenditure has been higher than the proportion of aid-financed development expenditure (Figures 3 and 8). The question is then, has aid really helped Indonesia in alleviating its fiscal constraint? The ratio of net resource transfer to GDP perhaps provides the answer. Before the crisis, the ratio was about minus 2.1 per cent on average. During the crisis it has dropped to about minus 0.3 per cent on average (see Figure 9). Thus in general it can be said that aid has reduced the fiscal burden during FY 1998/99, although the burden was not fully eliminated. The only positive figure was in FY 1999/2000 when the gross aid inflow exceeded the debt service, making the net resource transfer positive, and aid was particularly helpful to Indonesia.

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 per cent of GDP. In the post-crisis period, the development expenditure had to be cut significantly and by FY 2002 it was only 3.1 per cent of GDP. In the 2003 budget statement this expenditure was planned for a further reduction to only about 2.8 per cent. Because development expenditure is particularly important in stimulating private investment and sustaining economic growth, this low level of public investment may have contributed to the subdued growth of economy since the crisis.[37]

FIGURE 9
Net Resource Transfer as Percentage of GDP



SOURCE: *Financial Memorandum*, MOF, various years.

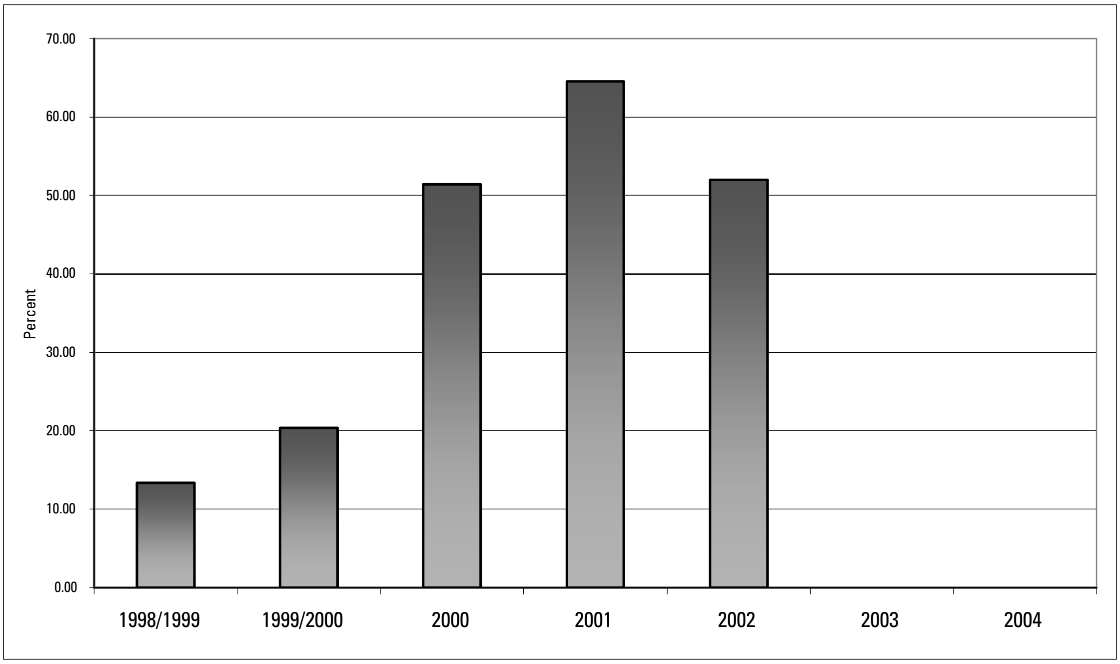
IV.2. The Paris Club Debt Scheduling

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 US$4.5 billion public debt that fell due between August 1998 and March 2000. ODA loans (US$3 billion) were rescheduled up to twenty years with a five-year grace period. For non-ODA loans (US$1.5 billion), the rescheduling would take up to eleven years with a three-year 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 US$5.8 billion — the principal due between April 2000 and March 2002. In addition, PC-III rescheduled US$5.4 billion of principal and interest that was due between April 2002 and December 2003.

Figures 10A and 10B present the impact of PC scheduling. As can be seen from Figure 10A, the amount of rescheduled debt represented close to 65 per cent and 54 per cent of development expenditure in FY 2001 and FY 2002, respectively. Assuming that revenue saved from the PC rescheduling is used for development expenditure, Figure 10B shows that the development expenditure during 2000–02 would rise to around 3 per cent of GDP. This is nearly double the amount without the PC rescheduling.

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 per cent larger than

FIGURE 10A
Fiscal Impact of Paris Club: Rescheduled Debt/Development Expenditure
(In Percentages)



SOURCE: *Financial Memorandum*, MOF, various years.

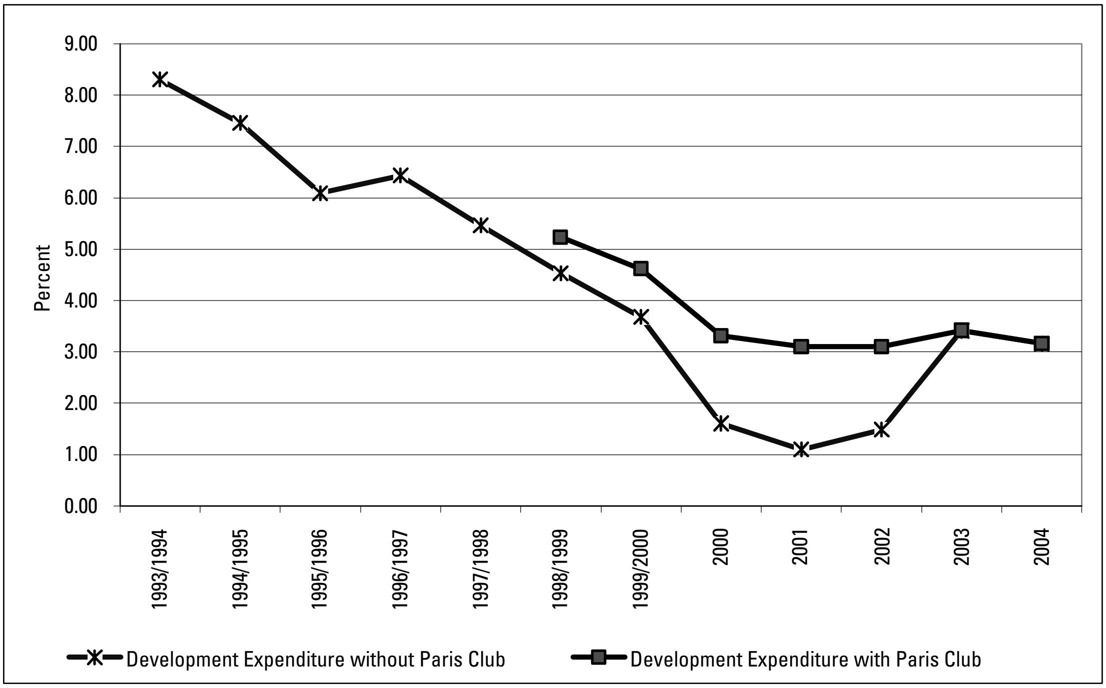
that of 2002 if the exchange rate is assumed constant at 9,000 rupiah per U.S. dollar.[38] With the end of Paris Club III in December 2003 when Indonesia exited the IMF program, 2004 marked the peak of public debt servicing. Thus, the uncertainty regarding fiscal sustainability remains unresolved.

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 (1986) that its effectiveness depends on many factors, not all related to economic factors has been echoed recently by Easterly (2003, pp. 39–40) in the following words:

> 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

FIGURE 10B
Development Expenditure with and without Paris Club as Percentage of GDP



SOURCE: *Financial Memorandum*, MOF, various years.

> 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 society-wide 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, and 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 was there 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, co-ordination (among government agencies, among donors and between donors and the government), and absorption capacity. Policy reforms, particularly with regard to governance and privatization, 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 per cent 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 two to three years time. Thus, Indonesia has to deal with the 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 privatization proceeds and other revenues. Measures for raising tax revenue included adjustments of tax brackets, coverage of VAT and administrative restructuring. These have resulted in an increase in the tax-GDP ratio from around 10 per cent to about 13 per cent. There is a prevailing view that tax is distortionary, and it would not be effective as there is widespread evasion and corruption. However, this view can be challenged in view of the 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 and 19 per cent. 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 subsidized through bank restructuring and recapitalization. Moreover, it is also possible to increase the tax base. The rate of value added tax is currently 10 per cent, but the total revenue from this tax is only 4.5 per cent of GDP. Thus the gap is about 5.5 percentage points, which also means that 55 per cent of goods are not taxed.

A crisis is an extraordinary circumstance and therefore sometime an extraordinary measure is justified. Malaysia and Chile introduced drastic capital control measures. 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 reunification cost of former East Germany. It was initially imposed at 7.5 per cent on all income and corporate taxes, and since 1998 is charged at 5.5 per cent. An advantage of such a levy is that it is temporary, and hence is unlikely to cause much distortion or disincentive. Furthermore, the fact that it is raised for a 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 the 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 two decades (1968 to 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 the 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 seven to eight years after the Latin American debt crisis of the 1980s. 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.

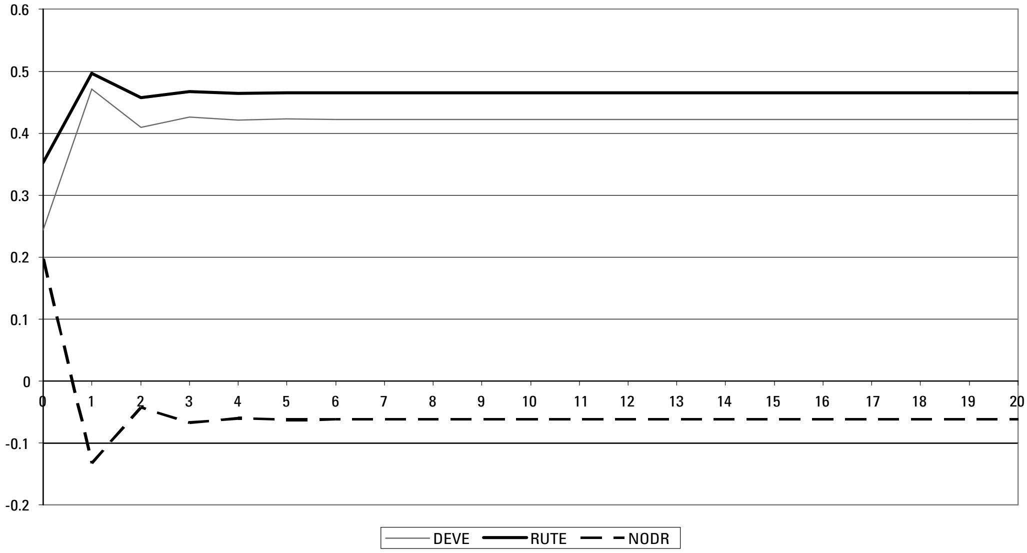
In this respect, it is perhaps time to reflect on the entire policy framework and the relationship between ODA with associated conditionality and private capital flows. Many observers have pointed out the likely adverse effect of a long list of structural adjustment programs. A number of factors might have contributed to a negative relationship between the nature of structural adjustment programs and investor confidence. First, a long and difficult list of structural adjustment might have signalled 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 were the conditions, the more difficult they were 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 a 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 the 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.

APPENDIX

Fiscal Response to Aid Flows: The Graph of Impulse Response Function

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 Expenditure and Non-oil Revenue

NOTES: DEVE = Development expenditure, RUTE = Routine expenditure, NODR = Non-oil domestic revenue (tax and non-tax revenue from non-oil sectors). The Y-axis represents standard deviation from mean and the X-axis represents periods (in this case years).

NOTES

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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* 114 (June 2004), and *International Review of Economics and Finance* 13 (2004) for most recent and comprehensive discussions of issues pertaining to aid effectiveness and aid allocations.
2. By 1992 developing countries were receiving US$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 US$48 billion a year (White 2004).
3. This reduction in aid flows is generally referred to as "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 (2003), 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. IDA is an arm of the World Bank to provide highly concessionary assistance to the world's poorest countries where the vast majority of people live on less than $2 a day. IBRD is the World Bank and funds long-term development projects.
6. See the statement by International NGO Forum on Indonesian Development (INFID) to the Eleventh CGI meeting held in Jakarta, November 2001.
7. See Mosely, Harrigan, and Toye, 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 summarized 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, Kwik Kian Gie 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 Consultative Group on Indonesia (CGI) in June 2002.
10. There was no domestic government debt before the crisis.
11. Nearly 80 per cent of development budget of 1969/70 fiscal year was financed through foreign aid. See Hill (1996, Figure 4.3, p. 46).
12. CGI is composed of bilateral and multilateral donors co-chaired by the World Bank and the Government of Indonesia.
13. Until 2000, the Indonesian fiscal year (FY) was from July to June; i.e. FY 1990/1991 refers to July 1990 to June 1991. Since 2000, the fiscal year (FY) is from January to December of the year.

14. In 1998, the Fund postponed loan disbursement three times: In March, May, and November. This automatically affected the disbursement of loans from the World Bank, ADB, and some bilateral lenders.
15. See Rajan and Sugema (1999) for Indonesia, Thailand, and Korea for a comparison of foreign reserves.
16. However, foreign reserves are still needed to contain speculative attacks.
17. 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 Bank Indonesia (BI) high-rank officials provide opposing views. One official said that the margin is slightly negative while another suggested a slightly positive margin. In addition, with the world economy heading a downturn, the margin would not be attractive (not possible to get a high return). On top of that, additional loans may complicate the task of fund management unit of the central bank.
18. In practice, a Fund program is virtually a *sine qua non* for countries wishing to negotiate a Structural Adjustment Loans (SAL) from the World Bank (Cassen and Associates 1986).
19. See Ramli (2002) for the arguments against the IMF involvement and its adverse consequences.
20. This point has been summarized in the first 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 US$54 billion in 2000; this was … only a small fraction of total investment (nearly US$1.5 trillion)." (World Bank 2002, pp. ix, xv).
21. For the conceptual framework of this analysis, see White and Hill (1996). Case studies based on this conceptual framework are contained in White and Dijkstra, eds. (2003).
22. The technocrat policy-makers did not give high priority to building local research capabilities, as they could easily obtain foreign technical assistance.
23. The gradual lifting of restrictions on foreign investment began in the mid-1980s, particularly in 1982 following the end of the oil boom.
24. See UNSFIR (2002) prepared by Sugema.
25. Hill (1996) and Gillis (1985). The results of these reforms have been impressive. In 1984, non-oil domestic revenue contributed to about 30 per cent of total government revenue. In 1996, just before the crisis, the share increased to 68 per cent.
26. Although the government has issued bonds amounting to 660 trillion rupiah, only 35 trillion rupiah is actively traded in the market. Hence, it would be difficult for the government to "recycle" the bonds.
27. Gray and Woo (2000).
28. The oil price boom in the 1970s has also played a role; see Hill (1996, p. 81).
29. See simulation results in the Appendix. Details are in UNSFIR (2002). The methodology followed is that of McGillivray (2002).
30. Yano and Nugent (1999) have shown both theoretically and empirically that if aid goes to finance the expansion of non-tradable and/or import-competing (protected) sectors, a "transfer paradox" may arise and the net welfare may decline. They found evidence of "immiserisation" effect of aid in Congo, Uganda, Bangladesh, and Nepal.
31. Pro-poor expenditure includes agriculture, housing, education, water and sanitation, and social security.
32. See Mauro (2002) for arguments linking corruption and infrastructure projects.
33. For example, the World Bank (1993) categorized Indonesia as one of the highly dynamic economies of East Asia. There was no hint of corrupt government-business relations despite the fact that 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.
34. The government also has to deal with domestic debt which was almost non-existent before the crisis.
35. Propenas is the Indonesian name for medium-term economic framework.
36. 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.
37. In contrast, Thailand experienced rapid recovery led by public expenditure.
38. See UNSFIR (2002) for simulation results on fiscal sustainability. Also see Nasution (2002).

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