



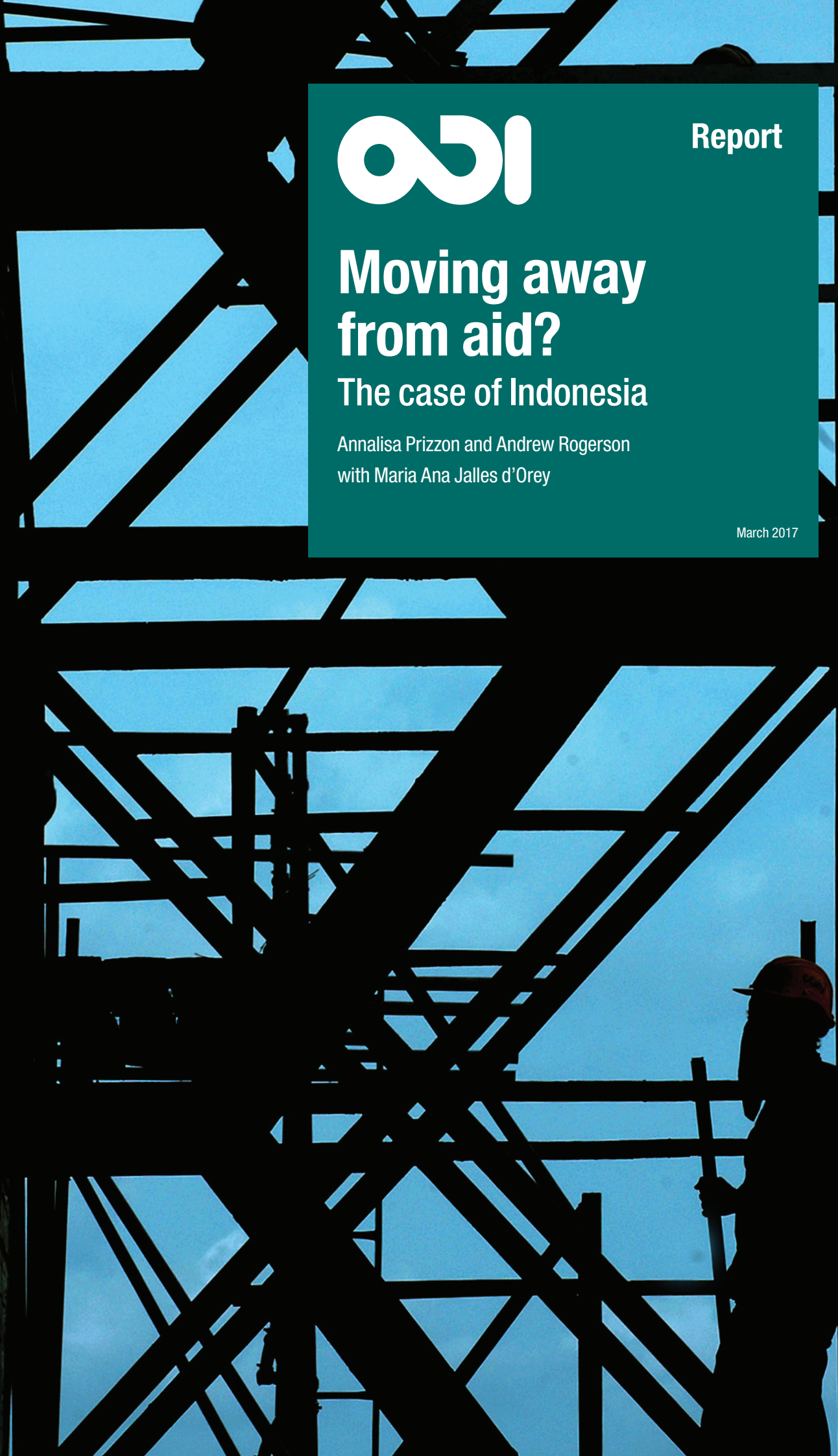
Report

Moving away from aid?

The case of Indonesia

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Acronyms

ADF	Asian Development Fund
AsDB	Asian Development Bank
FDI	foreign direct investment
CGI	Consultative Group on Indonesia
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
LIC	low-income country
LMIC	lower-middle-income country
MDB	multilateral development bank
MIC	middle-income country
MTDP	medium-term development plan
ODA	official development assistance
OOF	other official flows
RDB	regional development bank
SOE	state-owned enterprise

Executive summary

What does becoming a middle-income country mean for the national development finance landscape?

Over the past 15 years, 35 low-income countries (LICs) have joined the ranks of the world's middle-income countries (MICs): a reflection of the strong and sustained economic growth achieved in most parts of the developing world. As a result of this improved income status, every aspect of the development finance landscape is likely to evolve for those countries, from the sources of finance and financial instruments available to them, to the volume of aid and the conditions attached to it. One obvious result is their reduced need for traditional forms of aid. They are likely to see a reduction in funding from bilateral donors and a shift from grants to loans. The terms and conditions of sovereign loans from multilateral development banks (MDBs) will become harder.

The shift from grants to so-called 'soft' and then 'hard' loans can also alter the way in which aid is allocated between sectors. Given their potential returns and/or ability to generate cash flows, infrastructure projects, such as toll roads and utilities, tend to attract funding that is less concessional. The social sectors, however, such as education and health, tend to be supported either by public taxation or grants, rather than loans from donor governments (see Greenhill et al., 2013). Last, but not least, a country might find itself stuck in the 'missing middle' of development finance, as total resources available to a country fall as the country moves from LIC status until it is well into the MIC classification (Kharas et al., 2014).

Transition from concessional finance: the case of Indonesia

We do not have specific evidence whether countries have strategies for managing their transition from concessional to less-concessional financing. In this paper we illustrate the case of Indonesia. Indonesia is now eligible only for loans from the World Bank's 'hard' lending window, but the country's graduation to this status has not been smooth. Indonesia first graduated in 1980, but that was then derailed in 1999, following the Asian financial crisis, after which the country again became eligible for softer loan terms. Its second graduation occurred only in 2009.

An analysis of the development finance landscape in Indonesia reveals that, while the country has been climbing the economic ladder over recent decades, there have also been some significant changes in the relationship with its development partners.

The changing relationship between the Government of Indonesia and its development partners

The development finance landscape in Indonesia and the relationship between the government and its development partners has shifted during the transition from concessional to non-concessional finance. For example, the volume of official development assistance (ODA) fell when Indonesia graduated from the International Development Association (IDA) in 2009. The gap was filled, in part, by a rise in other official flows (OOFs) – official funding that does not meet ODA criteria. However, the importance of all official external sources as a share of total external financing, and of GDP and government revenues, has declined sharply since 2000. The financial impact of 'less concessional' loan terms since 2009 has also been considerably dampened by a long period of exceptionally low global market interest rates – a window which, from early 2017, may be starting to close.

While there were no major changes in Indonesia's core group of development partners during the transition from concessional finance, the nature of those partners' engagement has evolved.

- **As a group, MDBs are now the largest source of external official finance to Indonesia.** Bilateral donors, who contributed around 40% of official finance to Indonesia until 2003, have seen their share drop and hold stable at around 25% since 2010. Some financiers, such as China, the Export-Import Bank of Korea and the Islamic Development Bank, have been expanding their Indonesian portfolios.
- Traditional project finance from the World Bank and the Asian Development Bank (AsDB) has been largely replaced by general budget support instruments – Development Policy Loans from the World Bank and Performance-based Loans and Results-based Loans from the AsDB – and by sector-based development loans.
- The share of technical assistance in falling total ODA to Indonesia has increased over time, although its amount has remained roughly constant.

In 2005, the Government of Indonesia started regular issues of international bonds (increasing in volume for each tranche) and Sharia-compliant government securities. Several interviewees referred to international sovereign debt (and, by extension, domestic debt issuance, much of which is held by non-residents) as a 'residual', to be fitted

in as and when cheaper sources with longer maturities (including finance from the MDBs) were inappropriate, too rigid or not available.

Critically, the government has failed to expand domestic sources of finance as the share of external official finance has fallen; for example, as a share of GDP, revenues fell from 16.3% in 2005 to 15.5% in 2014. In essence, **Indonesia has become a typical example of the ‘missing middle’ conundrum: public revenues have fallen in tandem with declining external assistance as a proportion of the overall economy.**

Indonesia’s development effectiveness and debt management strategies have recognised the implications of changing status from a LIC to an MIC. This has meant a stronger focus on capacity-building and more effective use of a smaller amount of grant financing. Respect for national ownership of development programmes and alignment with national priorities are still at the top of the government’s list of desirable attributes for official development assistance.

Since 2007 there have been no formal mechanisms for structured coordination between the government and its development partners. **The government’s relationships and negotiations with development partners are firmly tailor-made and bilateral, often managed at the Presidential level,** and there are specific channels based on the category of funder and type of instrument.

About this report

This report focuses on how the Government of Indonesia has managed the transition from concessional to less-concessional finance. This case study disaggregates this analysis into two main research areas:

- evolution of the composition of development finance and of its characteristics (Section 3)
- national priorities for the terms and conditions of development finance and arenas of negotiations (Section 4).

Section 5 provides some conclusions arising from the experience of Indonesia in its transition from concessional to less-concessional financing.

Potential lessons for other countries and development partners

While our analysis is specific to Indonesia, it has revealed four potential lessons for senior government officials in developing countries which are currently diversifying their portfolios away from traditional development assistance and towards more market-related options, as well as areas for senior government officials in donor countries to consider when planning their own exit or transition strategy.

- **Adapt flexibly to changing supply terms** – which are decided largely unilaterally by the external official finance community – rather than trying to design and implement a deliberate strategy to ‘exit’ from aid. Indonesia’s pragmatism extends to its continued openness to policy advice from external agencies, including those (such as the World Bank) that had long been the focus of political resistance to foreign intrusion.
- **Practise sophisticated debt management.** The tension between rising demand for growth-oriented investment and the need for sustained debt discipline must be well managed. Indonesia’s debt management and investment planning have been central to its economic policy for some time, becoming increasingly sophisticated. Statutory caps on the central government deficit and overall debt have also imposed political discipline, especially since current revenues have stagnated. However, a note of caution that is not unique to Indonesia must be applied to government encouragement of off-budget financing, particularly direct international borrowing by state-owned enterprises (SOEs) with implicit state guarantees. This tactic circumvents fiscal and debt ceilings in the short term, but may pose contingent risks for the future. These need to be monitored effectively.
- **‘Bundle’ external finance with support for capacity-building** – regardless of the financial terms of loans and the speed of loan processing, which may favour some sources over others. Indonesian ministry officials were concerned about poor delivery by some government departments, local administrations and SOEs. They were particularly concerned about poor project selection, slow downstream execution and non-competitive pricing, which could wipe out any advantage gained from cheaper loans and/or faster processing. They appreciated the greater support offered by the MDBs and some bilaterals for project design, feasibility assessment and monitoring. They also saw technical assistance on cross-cutting issues – such as public financial management, decentralisation, etc. (even if not directly linked to large-scale financial support) – as underpinning it indirectly.
- **Prioritise mobilisation of domestic tax revenue.** The transition to lower dependence on foreign aid flows may become riskier if public revenues, particularly tax revenues, fail to grow. As noted, Indonesia exemplifies the ‘missing middle’ conundrum, and the looming 3% deficit ceiling piles on the political pressure and uncertainty (e.g. leading to sudden postponement of major investment projects), and leads to ‘creative’ off-budget financing that can store up problems for the future. An expanded menu of international financing options, however useful, does not overcome the need to mobilise greater domestic tax revenues.

1. Becoming a middle-income country: what does it mean for Indonesia's development finance landscape?

Over the past 15 years, 35 low-income countries (LICs) have joined the ranks of the world's middle-income countries (MICs), a trend that has mirrored the strong and sustained economic growth seen in most parts of the developing world. The development finance landscape of these countries – spanning sources, instruments, volumes of finance and financial terms and conditions – is expected to evolve as a result of their graduation to MIC status. There may well be common trends in this evolution associated with (i) the volume of assistance a country receives and its terms and conditions and (ii) the implications for partner country governments.

1.1. Volume of assistance and its terms and conditions

- **Reduced assistance from bilateral donors.** Bilateral donors tend to target their aid to lower-income and less-creditworthy countries, especially those with persistently poor or deteriorating human development indicators. It becomes hard for such donors to explain to their taxpayers why countries that have graduated to MIC status should still be eligible for 'soft' development assistance as they should be able to generate their
- own revenues. However, bilateral relations tend to evolve from traditional aid programmes to economic partnerships of mutual benefit in MICs.
- **More loans, fewer grants.** Donors offering a mix of grants and loans tend to disburse grants to the poorest countries, those which struggle to access international financial markets or mobilise domestic resources and which are at risk of debt distress (Kharas et al., 2014).¹
- **More expensive terms and conditions for sovereign loans from multilateral development banks (MDBs).** For most MDBs, when the annual income per capita of a country receiving concessional resources exceeds around \$1,200, this triggers a 'graduation' process. Once completed,² the country will instead be offered loans with higher interest rates and fees and shorter maturities and grace periods; transfers therefore change from being classified as official development assistance (ODA) to other official flows (OOFs).³ Such a shift is also often seen by bilateral donors as a signal to impose harder terms or phase out their programmes, even before the country graduates formally from the MDB's concessional window. It is worth noting, however, that in a global financial environment characterised by low interest rates, the gap between soft and hard terms has narrowed, masking (at least temporarily) the impact of this shift.

1. Grant and loan allocation for IDA eligible countries is based on the assessment of the risk of debt distress and the CPIA (Country Policy and Institutional Assessment) index.

2. The country should also be 'creditworthy' in order to be eligible for hard loans, i.e. be able to access international financial markets.

3. The current (although under revision) OECD definition of OOFs includes all transactions by the official sector with countries on the List of Aid Recipients that do not meet the conditions for eligibility as ODA or official aid, either because they are not aimed primarily at development, or because they have a grant element of less than 25% (see OECD, n.d.).

- **Greater borrowing from international financial markets.** Graduation from the soft windows of MDBs may be expected to be associated with more regular access to borrowing from international financial markets (and, in recent years, an increased appetite by such countries for the risks of the bond market).⁴

1.2. Implications of a changing development finance landscape for partner country governments

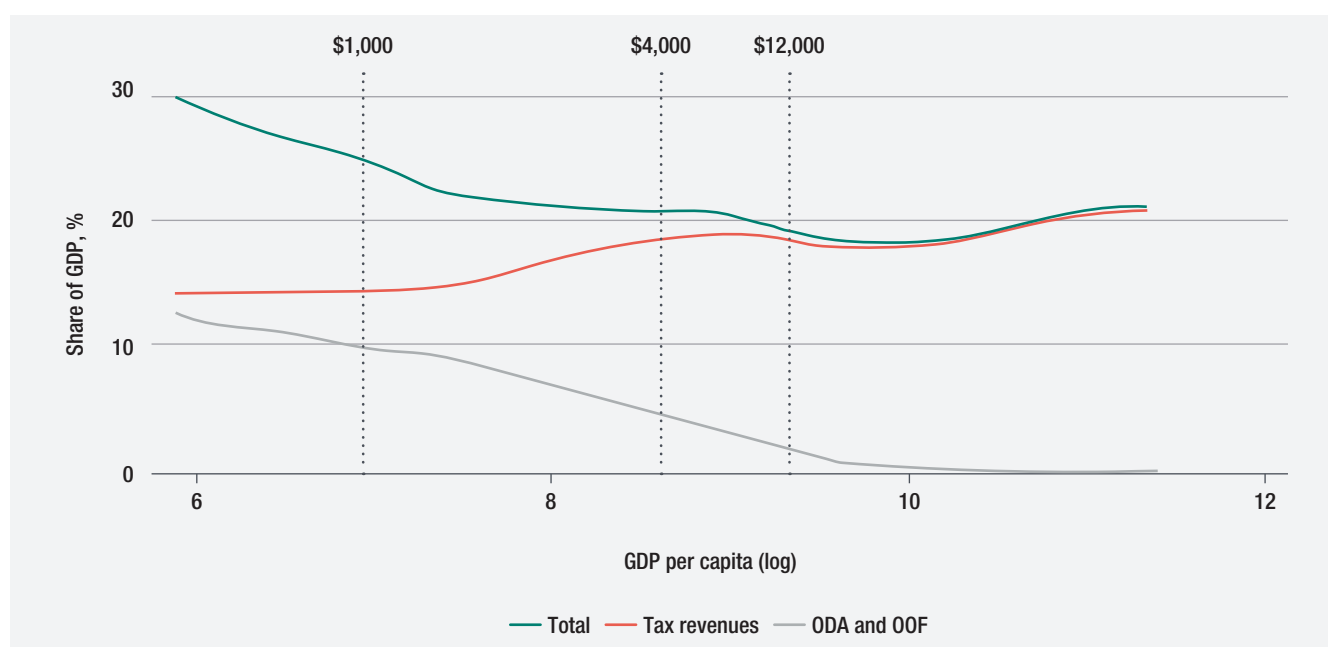
- **Lower dependence on aid.** All other things being equal, the contribution of development assistance to government budgets and as a share of GDP usually falls as a result of growth in the denominators (government budget and GDP), even when aid volumes stay roughly the same in absolute terms.
- **Changes in the sectoral composition of external finance.** Shifting from grants to soft and then hard loans can also mean that the sectoral allocation of external development assistance will change. Infrastructure projects tend to be funded using less-concessional finance, given their returns and/or ability to generate cash flows (as in the case of a toll road or a utility).

However, the social sectors – particularly education and health – tend to be supported either by public taxation or by grants, and partner country governments often turn down requests to finance these sectors (see Greenhill et al., 2013).

- **The ‘missing middle’ of development finance.** A country’s public resources fall continuously as a share of GDP until it is well into the MIC bracket, as international assistance falls faster than tax revenues rise (see Figure 1). Kharas et al. (2014) call this the ‘missing middle’ of development finance for countries joining the lower-middle income group. Just when many countries start to emerge from very low per capita income, their growth is constrained as domestic taxes and foreign private and market-related public borrowing fail to expand fast enough (and in some cases to expand at all) to compensate for the loss of concessional assistance.

How do these trends work out in reality? There is little evidence of how developing country governments have managed their process of ‘graduation’ from aid and its shifting patterns, or of transitional strategies from concessional to less-concessional financing. This report illustrates an example of a graduation process, using these trends as the main hypothesis for the analysis. Specifically,

Figure 1. The ‘missing middle’ of development finance



Source: Kharas et al. (2014).

4. See also footnote 2.

it examines the experiences of Indonesia,⁵ especially during the period 2000-2009 (leading up to its second graduation from the World Bank's concessional window) and in subsequent years. Indonesia first graduated from International Development Association (IDA) eligibility in 1980. Between 1999 and 2009, Indonesia had 'blend' status, meaning it had (initially limited) access to International Bank for Reconstruction and Development (IBRD) lending as well as some access to IDA funds. The

report analyses the implications of Indonesia's experience and draws lessons both for other governments (those that are starting a similar transition away from concessional finance) and for development partners (which may be planning to phase out their concessional programmes). It focuses on how the Indonesian government has managed this transition, rather than analysing the reasons driving donors' decisions on aid allocation to Indonesia.

Box 1 describes the methodology applied for this study.

Box 1. Methodology of the case-study analysis on Indonesia

This analysis adopted a mixed-methods approach. First, a desk-based review of relevant documents and background papers was conducted. This was followed by a descriptive analysis of development finance data. Finally, we conducted semi-structured interviews with government officials in Bappenas (Indonesian Ministry of National Development Planning) and the Ministry of Finance, development partners, former government officials and international civil servants in international organisations based in Indonesia, civil society organisations and academics. These were carried out between August and September 2016, either over the phone or in Jakarta during a one-week visit in September 2016.

This study builds on a political economy analysis developed in Prizzon et al. (2016), which looks at the extent to which partner country governments in LICs and LMICs received and benefited from non-traditional sources of finance and how they managed this greater complexity in their financing options. Our analysis has, however, adopted a longer-term horizon, and centres on a pilot study that looks at a country that is well advanced in its transition towards less-concessional financing and no longer has access to some financing options, such as concessional loans from MDBs.

We consider all development finance flows under the direct control of the government or state-owned enterprises, at least in principle, such as tax and revenues, bilateral and multilateral sovereign lending – both at concessional and less-concessional terms – commercial loans and international sovereign bonds. The analysis does not review financing to the private sector.

Our analysis has examined whether the Government of Indonesia had a strategy in place to manage the transition from concessional to less-concessional finance. The case study analysis is divided into three main research areas:

- **Composition of development finance:** How has the composition of Indonesia's financing evolved since the country's transition from the soft windows of MDBs, including taxation? Who were the main financiers – then and now? What are the main financing instruments and how have they evolved over time? What were the terms and conditions of the different financing options and how have they evolved? Is Indonesia an example of the 'missing middle' of development finance? How has the sectoral composition of both external and domestic sources of finance for the government budget changed over time?
- **Priorities and characteristics of development finance flows:** What were the government's priorities for development flows at the time of transition from concessional to less-concessional finance? Was there either an aid exit strategy or a financing strategy in place, or some key principles or elements of such an approach?
- **Arenas of negotiations:** How did the fora through which the government engages with providers of development finance evolve at the time of this transition from concessional finance? What strategies did the government use to negotiate with development finance providers over time?

5. The selection of Indonesia – a pilot case study – was based on the following criteria applied to MICs. We excluded: (1) small-island economies and countries with a population of less than 1 million inhabitants because of the challenges particular to their size and the small scale of their civil service and population; (2) high-income or OECD economies because of the longer time horizon required for such an analysis; (3) countries, such as those in the Commonwealth of Independent States, that have made the transition from planned to market economies; (4) fragile countries; (5) countries that have gone through a major political transition in the past five years; and (6) countries, such as Botswana, Namibia and South Africa, that have had major setbacks in health-related indicators (such as HIV/AIDS).

2. Transition from concessional finance

This analysis outlines elements of Indonesia's economic and political context from the 1997 financial crisis to the present day, to understand the factors that are driving and shaping the transition from concessional to less-concessional finance and the strategic decisions the Government of Indonesia took over this period. Indonesia's experience with external financial flows over the past two decades has been shaped, to a large extent, by the so-called 'Asian' financial crisis of 1997-1998 and its aftermath, especially rising foreign debt. This dramatic crisis has left its mark on government policies around foreign debt, as well as attitudes to foreign financing sources that persist today.

One obvious consequence of the financial crisis on official assistance to Indonesia was the reversal in 1998 of the country's graduation from IDA eligibility, first achieved in 1980, and a parallel return to concessional status with the Asian Development Bank (AsDB). The reversal meant there was a sharp initial reduction in lending volumes and a softening of terms, which were consistent with the government's objective to reduce debt and debt servicing and with the tightening of country allocations by concessional windows. Less-concessional lending then resumed progressively, initially in combination (blended terms) with IDA and the Asian Development Fund (ADF) equivalent, from which Indonesia only graduated in 2009.⁶

A second consequence of the crisis was Indonesia's Law on State Finances (2003), which enshrined fiscal and debt discipline in constitutionally binding terms – especially the Maastricht-inspired caps on the ratios of fiscal deficit to GDP (3%) and debt to GDP (60%). This tight policy response was driven by the recognition that the high debt burden generated by the crisis must not become a source of future instability.

The crisis obviously also affected Indonesia's relations with major foreign sources of official finance. Some of those sources are still widely perceived as having unnecessarily aggravated the depth of the resulting contraction in incomes and public services through their fiscally conservative advice and conditions.

Relations between the Government of Indonesia and the international financial institutions, and particularly the MDBs, have since improved, but they can still be rocky. One example is a recent speech by President Joko Widodo challenging the role of the World Bank, AsDB and International Monetary Fund (IMF) (*Jakarta Post*, 2015).

Other economic, political and social factors have shaped the ability of the government to attract flows of development finance. Compared with the economic, social and political disruption caused by the 1997-1998 Asian crisis, the global economic and financial crisis of 2009-2010 left Indonesia relatively unscathed. The country has recorded strong economic performance over the past 15 years, achieving average growth of around 5% each year and a credit rating that is improving progressively.⁷

Indonesia is the world's fourth most populous country and the world's largest Muslim-majority country. It is rich in natural resources and is among the top world exporters of several commodities. It therefore has strong geopolitical influence in the region. It is a founding member of – and leader in – the Association of Southeast Asian Nations (ASEAN) and a member of the G20. Inflows of foreign direct investment (FDI) and of foreign investors to Indonesia, especially from China, South Korea and Japan, are large and have been increasing.

Indonesia's access to MDBs became increasingly supply-constrained during the 2000s, as it hit the country-risk ceilings the MDBs set for themselves to limit their maximum exposure to a single borrower. More recently, increased supply from a newly capital-restructured AsDB, a country-focused Islamic Development Bank and the future Asian Infrastructure Development Bank, as well as loan-based bilaterals such as China, Japan and South Korea, are expanding the set of choices available.

Finally, Indonesia is a vibrant multi-party democracy – one of the world's largest – with a partly decentralised systems. Since 2002, a statutory requirement commits the government to spending at least 20% of its annual budget on the education sector – a target that has, for the most

6. Indonesia has since made some additional voluntary prepayment of outstanding IDA credits in IDA 17 (the 17th replenishment of IDA), and has pledged to become an IDA contributing partner. Indonesia is one of the IBRD countries – together with Brazil, China, India and South Africa – that have a single-borrower limit on exposure, increased to \$19 billion in the 2015 financial year, above which an interest surcharge of 50 basis points is applied each year. This is to discourage excessive portfolio concentration.

7. B+ with Standard & Poor's in 2004, BB in 2010 and BBB+ since then.

part, been met. A lower target applies to spending on health (5% of central government expenditure), according to the 2009 Law on Health.

Nevertheless, Indonesia still has a large and growing infrastructure gap (see IMF, 2016). Indonesia's investment in infrastructure as a share of GDP, at 3.4%, is one of the lowest in Asia, dwarfed by China's 10% and India's 7.5%. Several of the interviewees consulted for this study mentioned that funding of new infrastructure projects now takes many off-budget and partly-on-budget forms,

including subsidy injections and formal or implicit guarantees to SOEs. A more decisive shift of budgetary priorities toward economic infrastructure is still, for now anyway, constrained by the country's chronic weaknesses in its tax revenue base (see Section 3.1). Indonesia has increased its room for fiscal manoeuvre by allowing central guarantees for project finance to count only partially against the debt ceiling, and by allowing large infrastructure loans to be taken by state-owned enterprises without explicit sovereign guarantees.

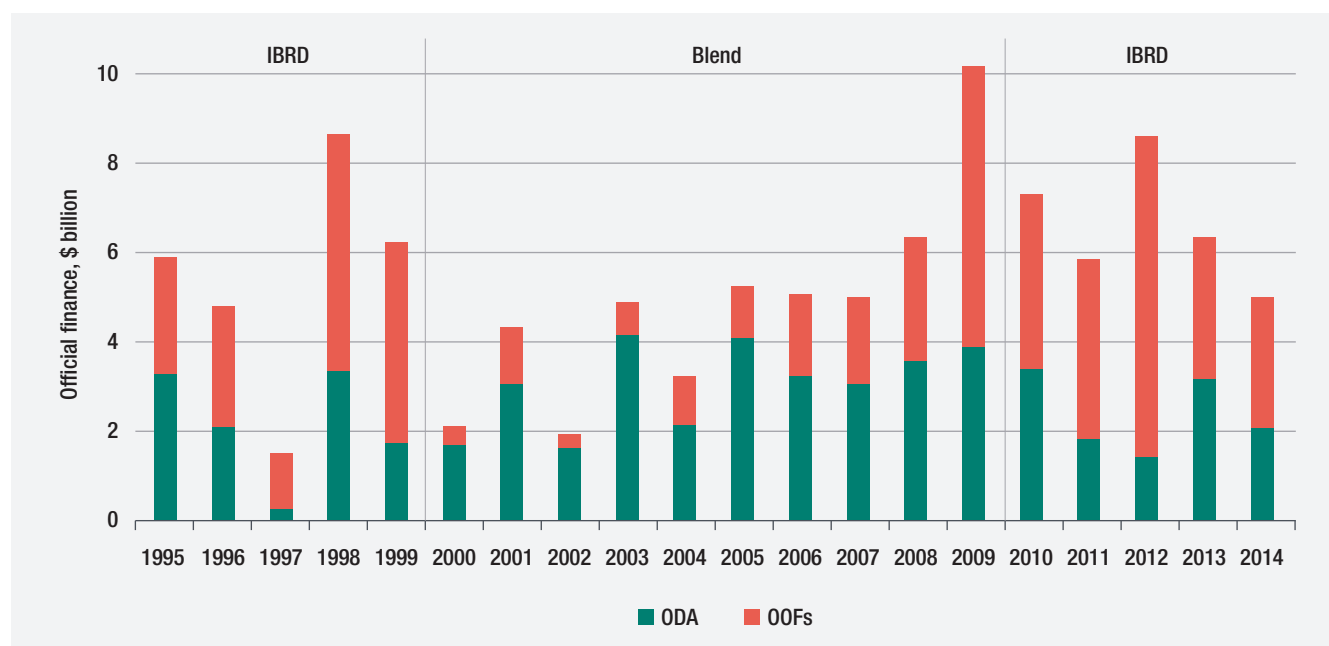
3. Moving away from aid: implications for development finance and sectoral allocation of external resources

3.1. How the development finance landscape has evolved: volume, composition and instruments

Eight main trends can be identified in the evolution of the development finance landscape in Indonesia since the early 2000s.

First, ODA volumes fell in absolute terms when Indonesia graduated from IDA (for the second time) in 2009. This fall was partly compensated for by an increase in OOFs, which signalled a formal shift away from concessional resources (Figure 2). ODA includes IDA-type loans but not IBRD-type ones (which are classed as OOFs), so IDA graduation automatically reduces ODA directly;

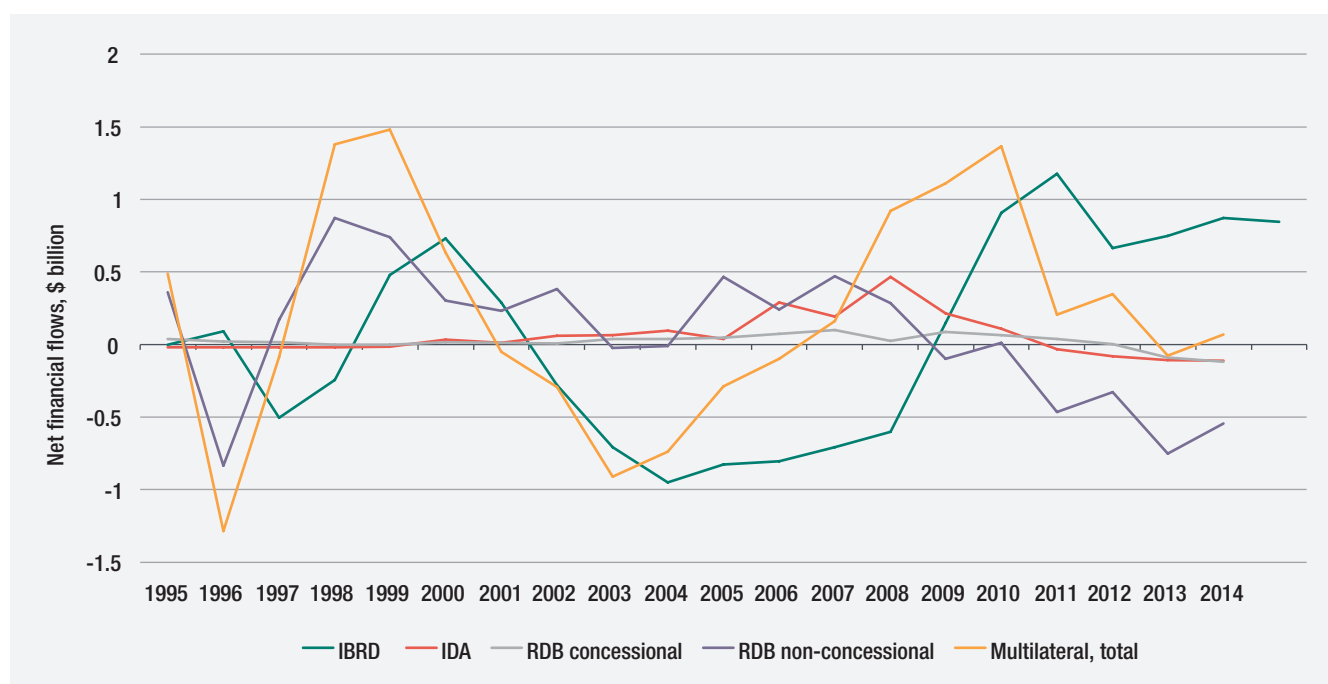
Figure 2. Total official finance (\$ billions) to Indonesia, current prices, commitments 1995-2014



Note: This includes official finance from countries within the Development Assistance Committee (DAC) and countries reporting to the DAC. IBRD and Blend refer to Indonesia's World Bank operational classification.

Source: OECD.Stat.

Figure 3. Net financial flows (\$ billions), IBRD, IDA and RDBs (concessional and non-concessional) to Indonesia, current prices, 1995-2014



Source: World Bank, *International Debt Statistics*.

graduation also reduces ODA indirectly, by signalling to bilateral donors to reduce their support and/or harden their terms.

Post-crisis ODA disbursements increased between 1998 (when Indonesia was granted IDA blend status) and 2009. However, they fell again from 2009 onwards, when the country again graduated to IBRD-only status.⁸ The more recent fall in ODA also reflected large absolute cuts in the Australian and Japanese bilateral programmes (the former since late 2014; the latter since 2009).

The increase in OOFs, at least in absolute terms, helped to fill the gap left by the reduction in ODA. In 2007, for example, before the transition from IDA eligibility, total official finance (ODA and OOFs) to Indonesia was approximately \$5 billion (\$3 billion in ODA and \$2 billion in OOFs). By 2014, the picture had been reversed: \$3 billion in OOFs and \$2 billion in ODA (Figure 2).

However, the MDB system as a whole still provides (small) positive net flows,⁹ thanks to a surge in IBRD lending (Figure 3). Multilateral bank net flows were negative from 2001 to 2007 mainly because of a dramatic fall in new World Bank hard-terms lending from its peak in 1999, which was reversed a decade later. Flows from non-concessional windows of regional development banks (RDBs) – notably AsDB – to Indonesia have been negative

since 2009. Negative flows from concessional windows (IDA and ADF) are no surprise as Indonesia is no longer eligible for such assistance.

Second, the importance of ODA and OOFs to Indonesia has declined since 2000 in terms of total external financing, both as a share of GDP and its contribution to government revenues. In 2000, ODA and OOFs accounted for 27% and 41% of total external flows to Indonesia, respectively.¹⁰ By 2013, their shares had shrunk to 8% and 11% of total external flows, respectively, as a result of expanding inflows of FDI and, to a lesser extent, workers' remittances. As a share of GDP, in 2002 ODA and OOFs were equivalent to 1.5% and 2.25%, respectively. They amounted to only 0.25% each in 2013 (see Figure 4). ODA as a share of the government budget reached a peak of 28% in 1988-1989, then declined to 4% in 1996-1997. The 1997 crisis reversed this trend temporarily (ODA contributed 24% of the government budget in 1998-1999, but it declined rapidly again to 4% in 2008 and has since stabilised (Bappenas, n.d.).

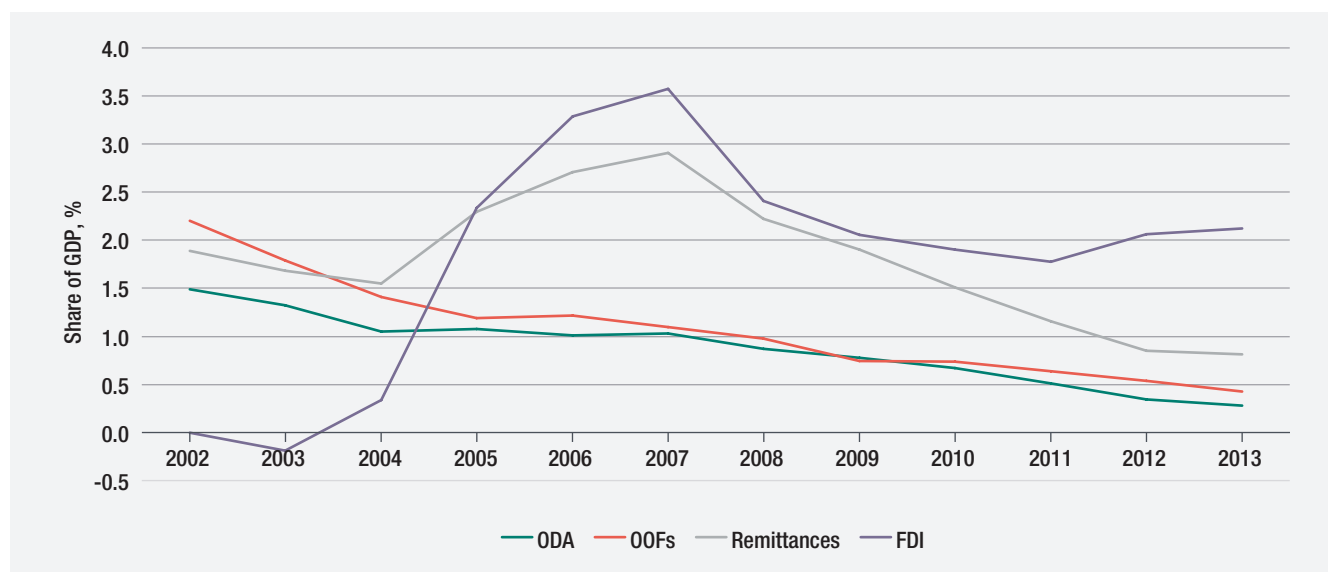
Third, the list of development partners active in Indonesia did not change substantially during the country's transition from concessional to less-concessional finance, but the composition, volumes and modalities of their resources and the nature of their engagement has evolved.

8. This is largely a definitional issue as IDA counts as ODA while IBRD does not, even when their terms are quite similar.

9. This definition does not factor in interest payments, which are significant and likely to rise in the near future.

10. Total external flows include FDI, workers' remittances, ODA and OOFs.

Figure 4. Indonesia: ODA, OOFs, remittances and FDI as a share of GDP



Note: Three-year moving averages.

Source: ODA and OOFs from OECD (2016). Remittances and FDI from World Bank (2016a).

Japan, the IBRD and the AsDB remained the top three donors to Indonesia throughout the 2000s, although the rankings of the three did change. The picture has changed somewhat since 2010, however. Between 2010 and 2012, the Import-Export Bank of Korea expanded its assistance, becoming the second largest development partner after the IBRD (on a commitments basis). Australia became the fourth largest provider between 2007 and 2009, but has fallen back more recently as a result of overall cuts in its aid programme.

By volume, bilateral donors used to contribute around 40% of official finance to Indonesia. Since 2003, however, the share has fallen, reflecting the rise in hard-window lending by the AsDB and World Bank. The share has been stable since 2010 at around 25%, given the recent cuts in the aid budgets of the Australian and Japanese programmes to Indonesia.

The financial instruments used by the World Bank and the AsDB to deliver assistance have also changed since 2005, shifting from traditional project finance to budget support, such as Development Policy Loans from the World Bank and Performance-based Loans and Results-based Loans from the AsDB. There has also been a shift towards the use of lending instruments that support sector-based development strategies. However, interviews with development partners suggested that such a change is unique to Indonesia.

China has become an important partner for Indonesia, providing loans mainly for infrastructure development. In 2011, Indonesia received the largest single package of Chinese finance announced for any country (loans and buyer's credit to the value of \$9 billion) (Asia Foundation, 2014). Total government exposure to Chinese liabilities has nearly doubled in recent years, from \$486 million in

2010 to \$938 million in August 2016 (Ministry of Finance, 2016), and it is set to expand further, according to our interviews with government officials.

There were a few bilateral donors that had a relatively small involvement in Indonesia before the 1997 crisis, and since then they have either cut their assistance still further or left the country altogether. Denmark, for example, has decreased its volume by 80% since 2005, from an already low base. Austria disbursed more than \$200 million in 2003, but no assistance was recorded in 2014. The Netherlands cut its programme by over 90% between 2006 and 2014 (from nearly \$350 million to slightly more than \$30 million). There is no evidence that the Indonesian government has ever urged any smaller donor to scale up or exit, let alone tried to do so across the board, in contrast to the deliberate decision by India (since reversed) in 2003 to limit its direct engagement to just six large bilateral donors. In 2014, only eight donors provided more than \$100 million to Indonesia (ODA and OOFs combined), down from 10 in 2005. A few, such as France and Germany, have expanded their programmes since the early 2000s, reaching or exceeding annual assistance of about \$300 million each.

Fourth, we find a mixed picture when we look at the terms and conditions attached to finance and their evolution over time. The average maturity on new commitments on official flows has been declining, from 24.5 years in 2000 to 17.6 years in 2014 (World Bank, 2016b), confirming the trends outlined in the introduction. Interest rates on new borrowing have, however, halved since the early 2000s (from nearly 3% in 2000 to 1.5% in 2014). Paradoxically, MDB financing was almost as expensive during Indonesia's transition as it is now, given the impact of the fall in global interest rates on the IBRD

and the progressive hardening of IDA terms applied to the country.¹¹ The graduation from soft windows of MDBs coincided with a sustained fall in global interest rates and, therefore, a closing of the pricing gap between so-called hard and soft loans. This has – so far – dampened the direct financial impact of graduation. Indonesia's borrowing from the World Bank is still being capped by the Bank's single-borrower limit, but this is less of a factor now for other lenders (e.g. the AsDB, which has newly acquired headroom through balance sheet optimisation).

Fifth, when it comes to aid modalities, the share of loans (both ODA and OOFs) has fallen over time (Figure 5). The share of loans in total official finance was 89% in 1996, before the crisis. It then started declining, reaching its lowest level of 70% in 2003, at the time of eligibility for IDA resources. The share of loans in official finance has risen again since then, but has remained well below 80% (with the exception of 2010). This runs counter to the initial hypothesis that MICs are increasingly likely to see their assistance take the form of loans, which they are now in a better position to service, and in a context characterised by rationing of grants in favour of poorer and less-creditworthy partners.

Sixth, the share of technical assistance in total ODA to Indonesia has increased over time. ODA-eligible technical assistance did not vary over the period, remaining more or less stable at around \$500 million each year. With ODA falling by one quarter over the period 2005–2014, ODA-eligible technical assistance has, in effect, been ring-fenced. The largest remaining sources of grant aid, such as Australia, increasingly combine a major share of their

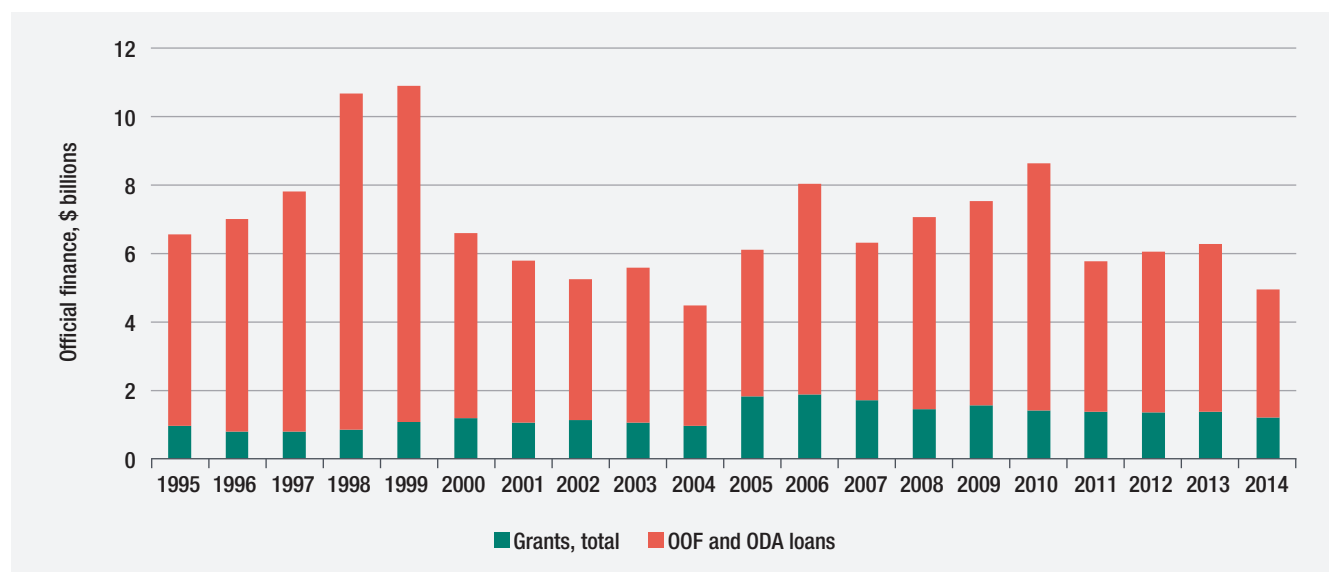
technical support with large multilateral loans, via trust funds managed by the MDBs.

Seventh, the Government of Indonesia has been issuing international bonds, with increasing volumes for each tranche, since 2005, as well as Sharia-compliant government securities, to raise external finance. Outstanding international government securities amounted to nearly \$17 billion in 2010 but had tripled by July 2016 (to \$48.5 billion) (Ministry of Finance, 2016). This includes, most recently, global bonds issuances, in two tranches of \$2 billion each at 10 and 30 years maturity, respectively, in 2014 (coupon rate of 5.875% and 6.750%, respectively; the IBRD has a maximum rate for spread of 1% over LIBOR for fixed spread products with a maximum of 18 months maturity) (Ministry of Finance, 2014a) and one of \$3.5 billion on 1 December 2016.

Finally, government revenues as a share of GDP fell from 16.3% in 2005 to 15.5% in 2014 (OECD, 2015). Over the past decade, domestic resource mobilisation has been among the top priorities of successive Indonesian governments, but it has proved very difficult to achieve. At the time of our visit in September 2016, there was much debate, including court challenges and demonstrations, around the government's offer of a one-time tax amnesty at favourable rates for citizens who repatriated their offshore funds. But even complete success with that initiative would not provide a durable solution to the structural revenue problem.

External official finance to Indonesia as a share of GDP has fallen continuously since the early 2000s, reaching close to zero. However, as described above, government revenues as a share of GDP rose until the late 2000s, but then fell in

Figure 5. ODA and OOFs to Indonesia: grant and loan composition (\$ billions), constant prices



Source: OECD.Stat Aggregate Aid Statistics.

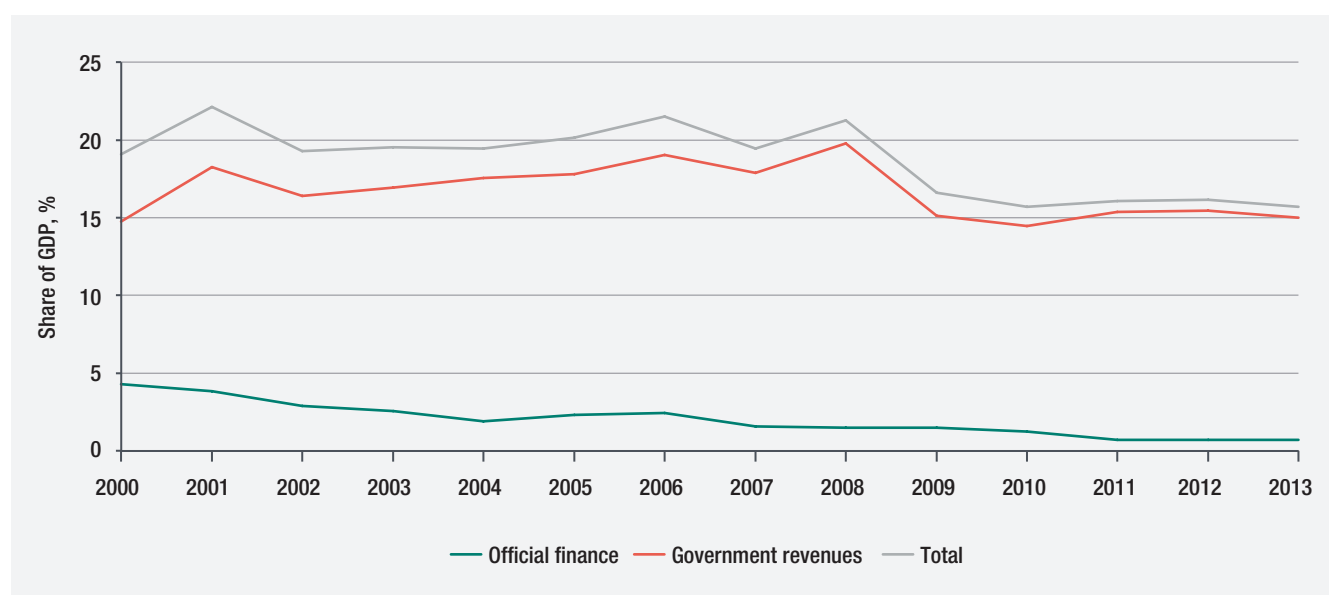
11. Until 2009, Indonesia was eligible for so-called IDA 'blend' terms, which combined the standard charge of 0.75% with additional charges, making the total cost not greatly different from IBRD terms, but with a longer maturity.

2009, and have remained fairly stable since. Since 2009, tax revenues have not expanded enough to compensate for the fall in official finance as a share of GDP. Indonesia is thus illustrative of the ‘missing middle’ of development finance, as explained in Section 1 (see Figure 1), at least since 2008 (Figure 6). Falling global commodity prices have also reduced government revenues (for instance, nearly 30% of government receipts between 2000 and 2007 were from the petroleum and minerals sectors (Arnold, 2012)).

3.2. Sectoral allocation of external and public finance

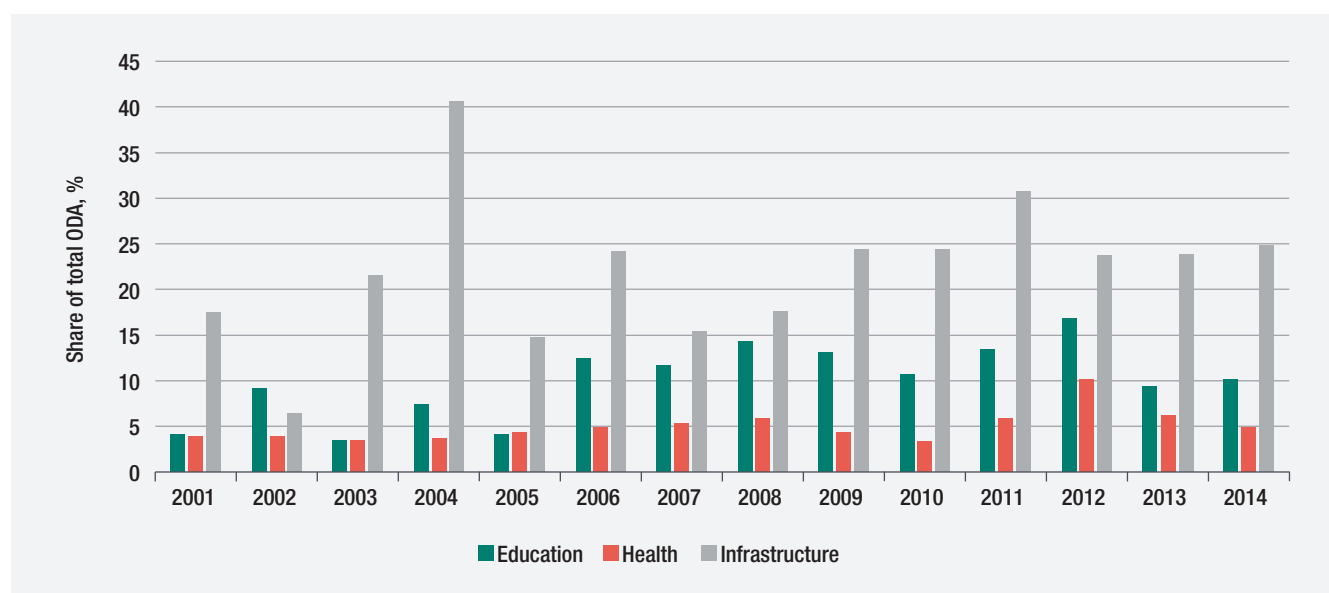
Even though absolute volumes of ODA might have fallen, as outlined in the previous section, the shares going to education, health and infrastructure have, in general, increased over time (Figure 7). In terms of ODA (remembering that the MDBs have not provided ODA since 2009), education has remained one of the top three sectors, as might be expected. Two of the largest bilateral

Figure 6. Trends in official finance and government revenues in Indonesia: an example of the ‘missing middle’ of development finance



Source: Budget data provided by Seknas Fitra; official finance data from OECD (2016).

Figure 7. Allocation of ODA to Indonesia by sector (% of total)



Source: OECD (2016).

donors to Indonesia (Australia and Japan) have continued to prioritise education consistently. Australia has, however, shifted its assistance to Indonesia from communities, education and health to support for economic growth and infrastructure development.

The hypothesis that resources will be shifted from social sectors to hard infrastructure does not seem to be backed up by the data, but this initial analysis requires a few caveats.

- First, debt relief and humanitarian aid fell over time, affecting the interpretation of the figures at the beginning of the period.
- Second, the large official agencies, especially the World Bank and the AsDB, have had a long tradition of engagement with Indonesia in education and health, particularly during the IDA and IDA-blend era (i.e. when loan-based finance moved to progressively 'harder' terms). Countries with a track record of successful IDA education programmes are also judged more likely to continue the relationship after graduation to IBRD terms (World Bank internal review, forthcoming).
- Third, when domestic public expenditure is a very large multiple of external assistance, as is the case for Indonesia (as discussed above), the question of fungibility arises. Regardless of the apparent earmarking of external funding for particular sectors and projects within them, what really matters is the government's capacity to establish clear priorities within and across sectors and then reallocate its own resources at the margin within that ranking structure.

According to interviews with core ministries, this positive relationship was reinforced by the use of an allocation rule, whereby 20% of government expenditure was allocated to the education budget (for which World Bank support was sought), to improve the overall impact and effectiveness of public spending. Conversely, interviewees challenged the proposition that borrowing on less-concessional terms for education was inappropriate for Indonesia because it was not directly cash-generating. This more restrictive view has been taken by several graduates from concessional windows, not least China. However, several Indonesian interviewees emphasised education's high economic returns via improved human capital and its growth effects. The MDBs have remained large funders of social expenditure since 2009, both directly (via projects) and indirectly (via budget support, though budget support is often sector-coded 'governance' when associated with overall macro-fiscal and anti-corruption reforms).

In the past few years, however, and particularly as a result of increased infrastructure demand on sovereign borrowing, there is more evidence (e.g. from published government plans and MDB partnership strategies) of a switch in external funding priorities toward economic infrastructure. The composition of MDB programmes has indeed shifted considerably toward 'economic'

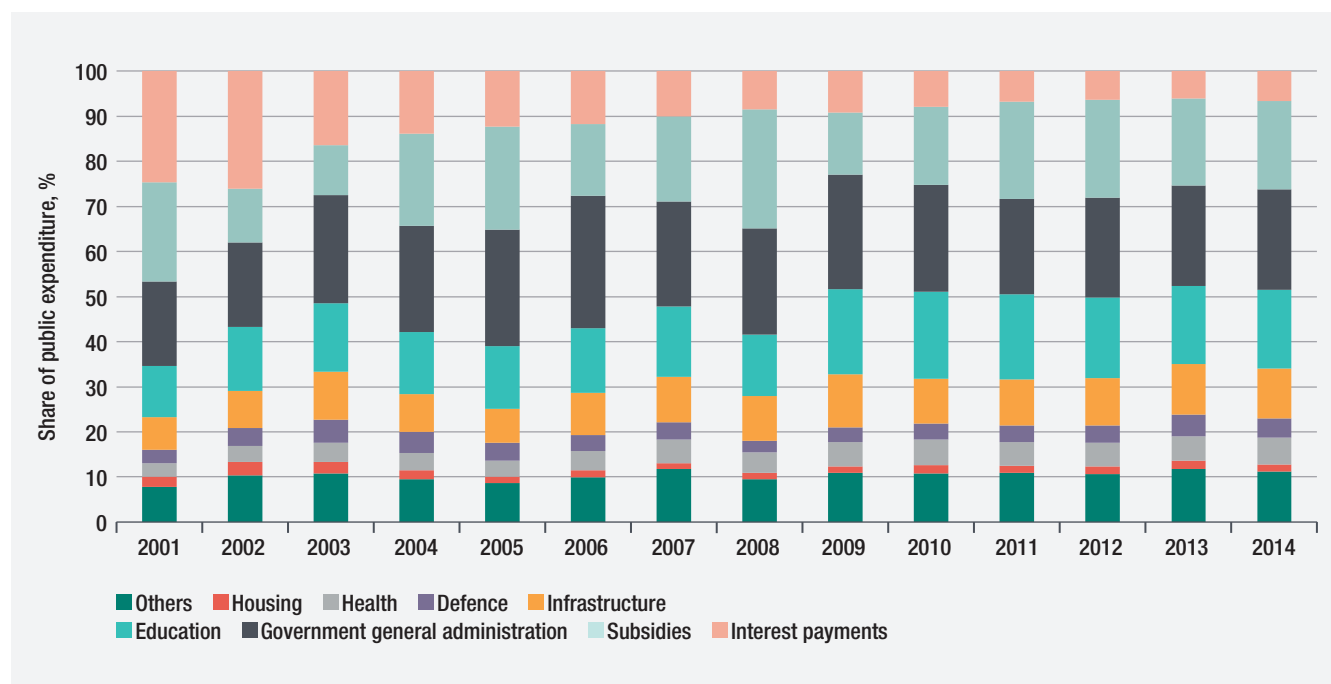
infrastructure, especially transport and energy more recently. In the current World Bank Country Partnership Strategy (2016-2020), for example, education features as only one of 13 items, in one of six major focus areas (improved local service delivery), with an indicative line allocation of up to \$150 million out of a total of \$7.5 billion for the whole period. Health is another line item within the same local-services cluster, with a slightly larger allocation of \$250 million. This means that together, education and health represent only around 5% of the overall forward programme. The structure of the 2012-2015 Country Partnership Strategy was markedly different so it is hard to compare quantitatively that strategy with its successor, but the nexus of jobs, education and technology appears to have had much higher visibility among the major pillars of the earlier programme.

Obviously, if and when the share of less-concessional loans from bilateral sources, including non-traditional sources such as China, continues to grow relative to the MDBs, the sectoral composition of external official finance is likely to swing even further toward cash-generating investments, especially those which can provide collateral for loans without direct sovereign guarantees (with contingent liability implications).

On the public expenditure side, the government does not seem to have shifted its own budgets in the social sectors downward in line with the fall in external assistance – a reaction that is predictable based on the fungibility principle discussed above, assuming these sectors remain equally important from a domestic perspective. This priority is partly attributed to the statutory requirement to spend 20% of the budget on education (mostly complied with), as well as 5% on health (compliance less clear). The MDBs are themselves well aware of the fungibility dimension, which helps explain why they are content to stay engaged in the 'soft' sectors with 'hard' windows, even when some regional MDB borrowers (such as China) have taken a narrower view of this matching of terms and sectors.

Spending on infrastructure development also rose, from 7% of total public expenditure in 2001 to 11% in 2014 (Figure 8). One of the explanations for why the shares of spending on the education, health and infrastructure sectors have grown since the early 2000s is that reductions in interest payments (due to tight fiscal discipline and internationally low interest rates) have provided the government with extra fiscal space. In 2001, one quarter of government expenditure went to paying interest on public domestic debt; by 2014, interest payments were 7% of government expenditure (World Bank, 2016c). Together with this effect, we found mildly positive correlations between government spending in the education, health and infrastructure sectors and ODA flows to these sectors (correlation coefficients of 0.39, 0.42 and 0.28, respectively) indicating that the Indonesian government has increased its allocation to all these sectors, more or less in line with those of its development partners.

Figure 8. Allocation of public expenditure, Indonesian government, by sector (% of total)



Note: 'Others' includes agriculture, social protection, religious affairs, tourism and culture, environment, economy, and public law and order.
Source: World Bank (2016c).

4. New government priorities and negotiations on external assistance reflect Indonesia's new middle-income country status

4.1. Government priorities for external assistance

Relevant policy statements issued by the Indonesian government over the 2000-2015 review period have three strands:

- an evolving debt management strategy, which sets out some key prudential goals
- principles of financing within a medium-term development plan (MTDP) and associated investment plans (the so-called 'Blue Book' of projects looking for funding and 'Green Book' of projects for which funding is secured)
- the 'Jakarta Commitment' of 2009, which anchored the Paris/Accra (and subsequently Busan) aid effectiveness principles into a new bilateral national dialogue with partners (superseding the Consultative Group on Indonesia, which was cancelled in 2007; see below).

The policy statements converge on four principles, as outlined in this section. However, the interviews suggested that the statements' impacts on policy implementation have been variable. For example, most of the external partners interviewed, and even some government officials, had never heard of the Jakarta Commitment on development effectiveness.

First, *recognition of the country's changed status* upon graduation from the LIC category and its IDA eligibility. The MTDP is very explicit on this: *'Indonesia will no longer be eligible for obtaining the most subsidised low cost loans from multilateral financial institutions.'*

Therefore, it is necessary that the management of foreign loans is strengthened and their utilisation is increasingly optimised.' This point also emerged in interviews with government officials. We could not confirm whether an explicit strategy to manage this transition was actually in place. However, the debt management strategy indirectly reflects the likely decline in the volumes and shares of concessional financing. The debt management strategy includes the government's objectives of optimising potential sources of financing from the domestic market through (i) the issuance of rupiah-denominated government securities and domestic loan disbursement, (ii) using foreign loans to finance priority projects at favourable terms and conditions for the Government of Indonesia (without having any political agenda from creditors) and (iii) maintaining the medium-term policy of reducing the outstanding balance of foreign loans (Ministry of Finance, 2014b).

Second, the Jakarta Commitment on development effectiveness clearly states that *ownership and alignment to national priorities* are still among the government's top priorities, reinforcing the Paris/Accra commitments. More specifically, the Commitment states that: *'the funding procurement from foreign sources, in the form of foreign grants as well as loans, must place the importance on Indonesia's sovereignty, national interest and should increase effectiveness of their utilisation in accordance with national development priorities.'*

Both priorities were emphasised in interviews with government officials from Bappenas. Clearly, alignment remains a core preference, shared with other countries. Development partners can support, at least in principle, only those projects that have been identified by Bappenas

in the 'Blue Book', i.e. projects for which the government does not have sufficient funding or that are highly complex and for which the government is seeking financial support (via co-financing) from one or more development partners. The list of projects in the 'Blue Book' is aligned with the MTDP. It could be argued, however, that project-level alignment with national priorities may not really matter, given the large share of budget support provided by Indonesia's main donors. The strategy of gaining more access to international financial markets (global bonds, sukuk bonds, samurai bonds) is also intended to strengthen the bargaining power of the government as a borrower (Ministry of Finance, 2010).

Third, *aid for capacity-building* is another priority in the Jakarta Commitment on development effectiveness and was one of the top priorities stressed by government officials in our interviews. Expectations about relationships with development partners are changing, evolving from mere financial transfers to capacity-building. More specifically, the Jakarta Commitment on development effectiveness states that: *'foreign loans and grants must be viewed not only from the funding point of view, but also as the means for exchanging information and experience in the context of strengthening and improving the national system of planning, budgeting, procurement, monitoring and evaluation and for strengthening the institutional capacity and human resources.'*

Regardless of the financial terms and the speed of loan processing, which may favour some sources over others, officials from Indonesia's core ministries were concerned about poor delivery by some government departments and SOEs. A specific concern was slow downstream execution and non-competitive pricing, which could nullify the nominal advantage of faster loan processing and/or cheaper sources. The officials appreciated the greater support in project design, feasibility assessment and implementation monitoring offered by the MDBs, as well as some bilateral lending agencies. However, lack of transparency and/or effective competition in bidding processes was said to be a drawback in some other cases, notably that of China.

Fourth, while acknowledging that the development finance landscape for Indonesia is changing and that concessional assistance is declining, *grant financing still matters, but needs to be used more effectively*. The MTDP still mentions the use of grants, with the government continuing to enhance the capacity of grant-receiving institutions and improve the implementing regulations on government grants management, making them more conducive and flexible while still accountable. This point did not, however, emerge clearly in our round of consultations.

Several of our interviewees referred to international sovereign debt (and, by extension, domestic debt issuance, a substantial portion of which is held by non-residents) as a 'residual', to be fitted in as and when cheaper sources

with longer maturities (including from the MDBs) are not available (Indonesia borrows heavily from the MDBs, so their country allocations can become entirely absorbed), simply inappropriate (e.g. because an investment could be predicted not to meet the lender's standards) or too rigid (e.g. because of the length of project preparation or because it cannot be used to finance recurrent expenditure). In practice, markets are tapped from time to time when conditions are judged most favourable, in parallel with institutional loans. Even so, the 'residual' tag fits in strategic terms.

4.2. Negotiations on external assistance

It is also worth noting that the essence of the current relationships and negotiations between the Government of Indonesia and external providers of official assistance (more and less concessional) is very firmly established as tailor-made and bilateral, often at the Presidential level, with specific channels established by category of funder (multilateral, bilateral) and type of instrument.

Until 2007, the government and its development partners used to meet formally twice each year. The Intergovernmental Group on Indonesia, established in 1992, was renamed the Consultative Group on Indonesia (CGI) in 2000 (Edi and Setianingtias, 2007). According to these authors, the focus of the discussion was primarily a review of the performance of the Indonesian economy, rather than the performance of donors. In January 2007, President Susilo Bambang Yudhoyono dismissed the CGI, given that most of Indonesia's foreign assistance was coming from just three donors (the AsDB, the World Bank and Japan), with whom direct communication was well established and for whom coordination was no longer seen as necessary. Finance Minister Sri Mulyani said that Jakarta would prefer to operate through bilateral channels rather than *'having to go through a long, meaningless ceremony'* (ANTARA News, 25 January 2007).

The adoption of the Jakarta Commitment on development effectiveness in 2009 by the government and 22 bilateral and multilateral donors was seen as a process to restore the government's relations with development partners after the CGI was discontinued. However, the government has been quick to state quite clearly that the: *'Jakarta Commitment is an effort to improve independence in utilising foreign aid, not a replacement of the CGI'* (quoted in Edi and Setianingtias, 2007).

In conjunction with the signing of the Jakarta Commitment, the government established the Aid for Development Effectiveness Secretariat (A4DES) within Bappenas. The Secretariat steering committee is chaired by the Bappenas Deputy Minister for Development Financing, who sets the general directions of the institution, and a management committee that implements the decisions of the steering committee. An initial set of six working groups – intended to include both the government and

development partners – was established: on procurement, dialogue and institutional development, public financial management, monitoring and evaluation, capacity-building and knowledge management, and the development of

finance mechanisms. It was not clear at the time of our visit whether these arrangements were still active, or are being allowed to lapse and/or be mainstreamed into other government institutional processes.

5. Conclusions and lessons

Aid to Indonesia had remained relatively constant in absolute terms until recent major cuts in some bilateral grants. Since 2009, the effects of hardening of loan terms have also been dramatically reduced, compared with what might have been seen in earlier eras, by historically low interest rates. At the same time, the arrival of new finance providers – particularly China – has provided more options for obtaining resources, including some that circumvent Indonesian constitutional caps on sovereign debt. Some of our interviewees felt that this transition was due entirely to external factors, with the Indonesian government simply reacting to changing circumstances.

More fundamentally, perhaps, Indonesia had a harsh introduction to the volatility of foreign funding of all kinds when, among more serious consequences, the debt crisis of the late 1990s reversed its first graduation from IDA status. In the aftermath of that crisis, charting yet another linear course to graduation from aid may have appeared too ambitious – it would be more feasible to aim to achieve graduation as a by-product of successful economic recovery and growth, not as a first-order objective.

While our research has been grounded in one specific context – the experience of Indonesia – five main reflections have emerged that other economies starting their transition from concessional finance could consider. Like Indonesia, they face likely changes to the volumes and terms of official assistance and other aid flows offered by bilateral and multilateral partners. These are also areas senior government officials in donors' countries should consider when planning their exit or transition strategy.

- *There was no deliberate strategy to graduate from concessional aid.* Indeed we found no evidence of one in Indonesia's case. Rather than following a strategic plan, Indonesia seems to have adopted the more pragmatic 'management' of the consequences of an ever-changing context. The country's graduation from relying on aid (of all types) as a major component of its national income has been just one result of this changing context, associated primarily with the dynamic growth of the Indonesian economy since 2000, rather than the supply of (or demand for) aid. No official source of external finance is thought to have been turned away by the government since 2000, although funding switches at the project level have sometimes been quite abrupt (e.g. the Jakarta–Bandung Railroad, where China was selected rather than Japan very late in the day). Indonesia's pragmatism extends to its continued
- willingness to take policy advice from influential external agencies, including those (e.g. the World Bank) that have been the focus of political resistance to foreign intrusion for years. Several interviewees suggested that concerns about interference by foreign actors remain a potent political rallying point. However, such concerns are reported to surface only sporadically, especially around national elections, while day-to-day dialogue with such actors is benign and discreet.
- *The tension between the demand for growth-oriented investment and the need for debt discipline needs to be well managed.* Indonesian debt management and its closely related investment planning apparatus have been central to economic policy for a long time and both have become increasingly sophisticated. The trade-off between the dynamic push for growth based on massive economic infrastructure investment and an 'immovable constraint' of containing central government budgets and debt will be familiar to many other MICs. Indonesia has been pragmatic since the 1990s' Asian financial crisis – a term echoed in several interviews – in obtaining the best 'fit' from a diverse array of sources of assistance and borrowing. One note of caution that may also resonate with other countries relates to the government's encouragement of off-budget financing, particularly in the form of direct international borrowing by SOEs with implicit state guarantees. This may circumvent fiscal and debt ceilings in the short term, but may also pile up dangerous levels of contingent risk for the future. Such large decentralised public investments may also prove to be based on inadequate project selection and/or procurement disciplines, increasing their costs and lowering their returns.
- *The 'bundling' of finance with support for capacity-building is increasingly important.* The major remaining sources of grant aid to Indonesia, such as Australia, increasingly combine a major share of their technical support with large multilateral loans, via trust funds managed by the MDBs. The impact of these bundled packages was seen as beneficial, but government officials also felt they were becoming too complex and opaque, especially if compared with other options for Indonesia, when dealing with each development partner individually.
- *The transition to lower dependence on foreign aid flows may become riskier if public revenues fail to grow.* Indonesia exemplifies the 'missing middle' conundrum, with public revenues failing to grow (or even falling, in the case of Indonesia) while external assistance falls

rapidly and, ultimately, ceases to be significant as a proportion of the economy. This heightens, for several years at least, dependence on private transfers (FDI, remittances, portfolio flows, etc.), which are subject to volatility. In Indonesia's case, the ever-closer approach of the 3% deficit ceiling just adds to political pressure and uncertainty (which have led to unexpected delays or cancellations of public investment launches), and encourages 'creative' off-budget financing that could lead to problems in the future. At the time of our visit to Indonesia in September 2016, the government's offer of a one-time tax amnesty at favourable rates for citizens who repatriate their offshore funds was the source of debate, court challenges and, even, demonstrations. Even if this initiative were to succeed in full, it is not a durable solution for Indonesia's structural revenue problem.

- *The transition to harder terms need not necessarily result in a shift in government demand for loans from the social sectors to 'cash generating' economic infrastructure.* The MDBs have invested in Indonesian education in particular for decades, and education remains a significant element in their current programmes, although the social sector's share in new commitments is declining. Indonesia is a special case, with its statutory requirement to spend 20% of its budget on education and 5% on health. The

decentralised nature of much of this spend and its huge size relative to external official support for it means that external sources, while doubtless contributing qualitatively, do not have much impact on the underlying sectoral composition of national expenditure: this is a classic fungibility case whereby external aid ostensibly directed at a particular purpose in fact displaces government spend at the margin which is available for other purposes. Since about 2012, however, and particularly given increased infrastructure pressures on sovereign borrowing, there has been more evidence (e.g. from published government plans and MDB partnership strategies) of a switch in external funding priorities toward economic infrastructure. This gradual switch within the MDB spectrum is amplified by the progressive change in the overall mix of lenders and borrowers. There has been a rising share of bilateral buyer credits (in particular, those offered to sub-sovereign entities) and related project finance, and a correspondingly falling share of traditional sovereign-focused MDB loans. Therefore, even if the central authorities remain content to take on some sovereign debt for the social sectors, overall loan demand is increasingly driven by decentralised borrowing, typically by cash-generating enterprises. This will shift the overall sectoral composition of foreign funding ever more strongly towards 'economic' infrastructure.

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