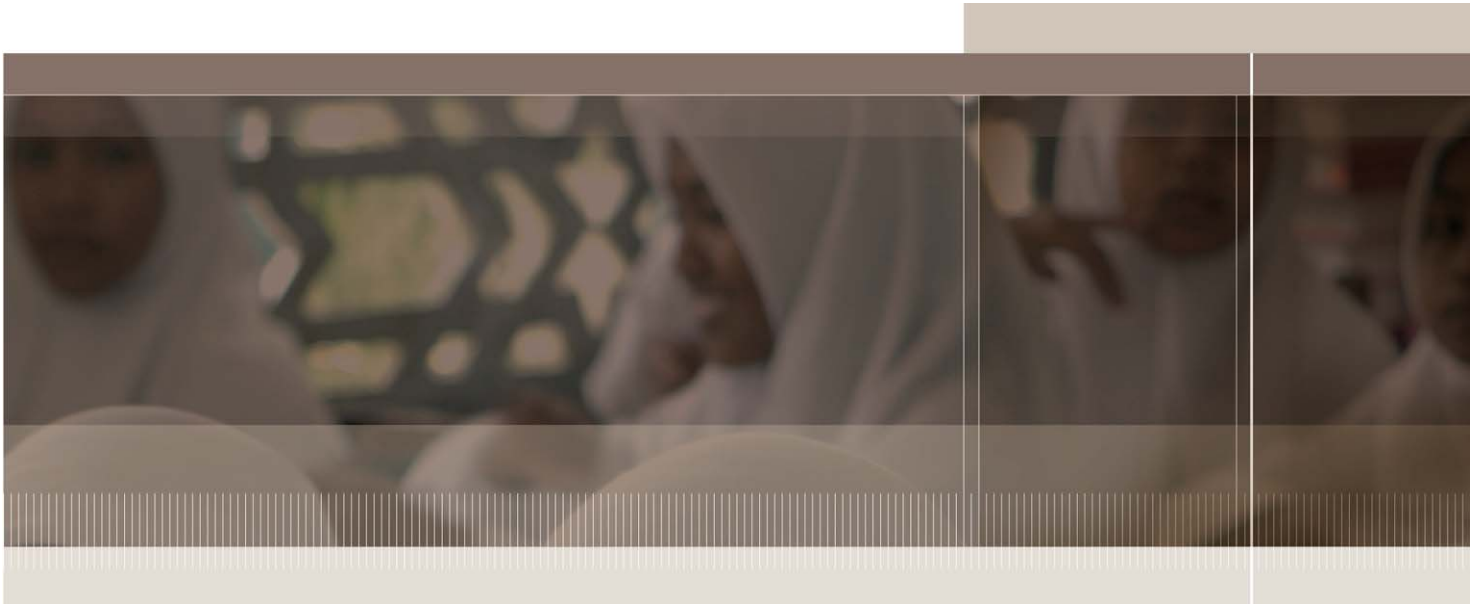


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# Making a difference in middle-income countries?

AN OFFICE OF DEVELOPMENT EFFECTIVENESS  
ASSESSMENT OF FUTURE SUPPORT TO INDONESIA AND  
THE PHILIPPINES: ISSUES AND IMPLICATIONS



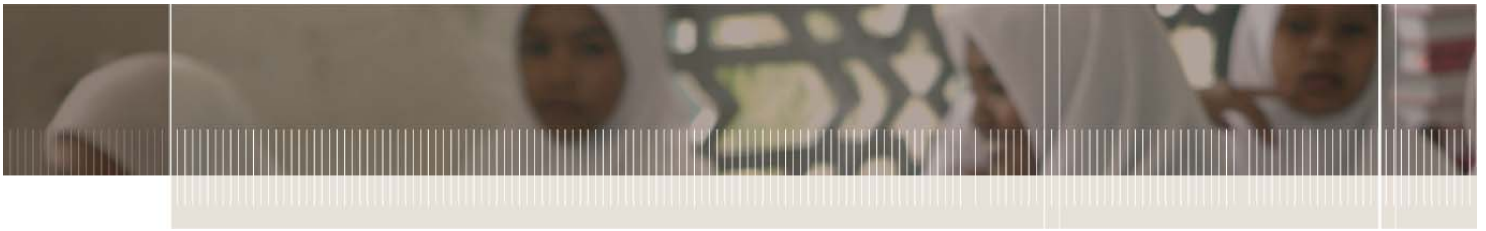
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Drafting of this report was completed in June 2008. It therefore essentially predates the current global financial crisis. Although policy makers in all three countries are now understandably focused on the crisis, we believe the longer-term issues discussed in this report will again occupy centre stage once the crisis has passed.

## Abbreviations

ACIAR	Australian Centre for International Agricultural Research
ADB	Asian Development Bank
ADF	Asian Development Fund
AIPRD	Australia-Indonesia Partnership for Reconstruction and Development
ANU	Australian National University
ARDE	Annual Review of Development Effectiveness
ARMM	Autonomous Region of Muslim Mindanao
ASEAN	Association of Southeast Asian Nations
AusAID	Australian Agency for International Development
BAPPENAS	Badan Perencanaan Pembangunan Nasional
CGI	Consultative Group of Indonesia
DAC	Development Assistance Committee
DPR	Dewan Perwakilan Rakyat
DSF	Decentralization Support Facility
GDP	Gross Domestic Product
GNI	Gross National Income
DFID	Department for International Development
FIES	Family Income and Expenditure Series
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFIs	International Financial Institutions
JBIC	Japan Bank for International Cooperation
JICA	Japanese International Cooperation Agency
LGUs	Local Government Units
LMICs	Lower-Middle Income Countries
MCC	Millennium Challenge Corporation
MDGs	Millennium Development Goals
NEDA	National Economic and Development Authority
NGOs	Non-Governmental Organisations
NRIMP	National Road Improvement and Management Program
ODA	Official Development Assistance
ODE	Office of Development Effectiveness
OECD	Organisation for Economic Cooperation and Development
PDF	Philippine Development Forum
PIDS	Philippine Institute for Development Studies
SMERU	Social Monitoring and Early Response Unit
TA	Technical Assistance
TNI	Tentara Nasional Indonesia

## Executive summary

### Assessment purpose and structure

The Australian Government intends to meet an aid target of 0.5 per cent of gross national income (GNI) by 2015. This represents approximately a trebling of aid flows in a little over a decade. But there are challenges inherent in spending this additional aid effectively. This assessment, undertaken by AusAID's Office of Development Effectiveness (ODE), asks at a broad level how a major increase in aid might effectively be spent in Indonesia and the Philippines and, by extension, in lower-middle income countries (LMICs) in general. It does this by identifying common themes about the future role of Australian aid in the two countries, based on a two-week field trip to both. In this way it differs from a typical assessment of Australia's ongoing development assistance program to the two countries.

This assessment is a broad overview based on the fieldwork conducted in Indonesia and the Philippines during April 2008. Its conclusions are aimed particularly at AusAID's most senior managers and at the Australian Government, rather than the managers of the two country programs. Further investigation is recommended, in the form of a series of case studies exploring selected issues in greater depth. These case studies will be of more practical value to the country program managers.

This assessment looks at the political and institutional settings in the two countries and their aid environments, and draws broad conclusions for the direction of scaled-up Australian aid in Indonesia and the Philippines.

### Context

**Political and economic features:** Indonesia and the Philippines face similar challenges. Both have weakened presidencies and, for different reasons, suffer from somewhat indecisive and politically constrained governments. Macro-economic policy is generally well managed, but both countries have found it difficult to effect important micro-economic reforms. Human capital is quite low, with a particular shortage of good quality graduates, especially in Indonesia. Both countries have extended democracy and fiscal authority to their regions, but major challenges exist in exploiting this change for improving service delivery and creating jobs. Both perform poorly on surveys of the cost of doing business and corruption, and struggle to encourage adequate domestic and foreign investment.

**Social features:** The two countries have low per capita incomes at around US\$1400. Both appear to have experienced slight increases in poverty as a result of recent food price rises. Over the past decade, neither has managed to grow at rates that would accelerate reductions in poverty. Both have found it hard to deliver good quality health and education outcomes. National-level indicators disguise considerable regional disparity, something that has proved intractable in both countries over the past decade—the per capita income of the National Capital Region in the Philippines is 12 times that of the Autonomous Region in Muslim Mindanao, for example.

**Aid environment:** Both Indonesia and the Philippines have middle-income status, so concessional lending through the International Development Association (IDA) and the Asian Development Fund (ADF) is no longer an option. While both countries continue to access market-based loans from international financial institutions (IFIs), net disbursements after repayments are expected to be low or negative over the medium term. Middle-income status also sees some bilateral donors winding back their programs, notably the Department for International Development (DFID) in the United Kingdom, Canada and the Nordics. By contrast, increases in the aid budget have seen Australia become a prominent player in both countries. Particularly important is the grant-based, untied nature of Australian aid. This gives greater flexibility to the recipient country, together with lower costs. The Philippine Government's performance with aid coordination capacity seems the stronger of the two countries, despite recent improvements in Indonesia.

## Australian aid

**Bilateral relationship:** The Australia – Indonesia relationship is mature and well established, across commercial, defence, educational and foreign policy areas. Australia is now the second largest net donor in Indonesia, after Japan, with an annual program in 2007–08 valued at A\$459 million. Australia awarded 281 scholarships to Indonesian students in 2007, and many senior officials and politicians are alumni of Australian universities. The United States has been the dominant bilateral donor in the Philippines. The Australia – Philippines relationship is not as well established, however. Although the aid program is now worth A\$100 million, there are mixed views in the Australian Government on whether this should be further increased. Reflecting the difference in the strength of the bilateral relationship, 2007 saw 78 scholarships awarded to Philippine students.

In the view of the authors, the justification for Australian aid to both countries is based around five factors.

1. persistence of poverty—almost 50 per cent of the population in both countries lives on less than US\$2 per day and is vulnerable to slipping back below the US\$1-a-day threshold
2. inconsistent progress against Millennium Development Goals (MDGs) points to shared difficulties in delivering good quality public education and health care in particular
3. significant human and organisational capacity issues that are holding back progress
4. important strategic issues, particularly around Aceh and Mindanao, which are also attracting an aid response
5. global climate change concerns argue for an aid-based response, especially around reducing emissions from deforestation and forest degradation in Indonesia.

**Current program directions:** Recent years have seen significant changes in the Indonesian and Philippines programs. Both have recently completed new country strategies, which reflect their development priorities and expanding Australian aid programs. Both AusAID programs have enhanced the roles and capacity of in-country offices and have worked more closely with the IFIs. In Indonesia, the introduction of the Australia-Indonesia Partnership for Reconstruction and Development (AIPRD) in 2005 led to a doubling of the aid program and greater exposure to government systems. At the same time, both programs are still coming to grips with what it means to be a prominent aid donor in countries where aid does not dominate policy and resource allocation decisions. This requires a deeper knowledge of the countries' development challenges, more flexibility to find niche roles and respond to reform opportunities, and new types of partnerships with national and local governments, the donor community, academics and non-government organisations (NGOs).

## Spending more money more effectively

In Indonesia and the Philippines, in the view of the authors, development needs appear to converge around institution building, strengthening of human capacity, selective support of realistic policy reforms, and some regional focus, particularly to support poor but progressive regions. The possibility of significantly increased funding poses new challenges and opportunities for both countries. In Indonesia, for example, where the Australian and Indonesian governments have fashioned for the most part a deep, durable and mature partnership, there are opportunities for policy engagement in important and sensitive areas, including in public financial management. The Philippines presents different challenges. A less developed bilateral relationship means policy engagement in key central ministries is more challenging. Nonetheless, the aid program there has achieved some success in supporting education policy reform.

The capacity-building challenge would remain central to both country programs regardless of scale. But larger programs arguably present more flexibility and more profile to address this challenge. This has been particularly apparent from the engagement of the AIPRD in infrastructure.

To date, both AusAID programs have spent heavily in priority regions, especially in Mindanao, Eastern Indonesia and Aceh. Should further spending increases take place, however, the scope for achieving a lot more in these regions, where other donors are also active and absorptive capacity is limited, may be

questioned, not least through strong partner government pressures for broader engagement. Inevitably, the focus will shift to national programs, issues of centre-local relations, and support for progressive local governments in other poor regions.

With significant shortages of good quality local graduates, both country programs could look more closely at support for tertiary education. This is emerging as a critical weakness in Indonesia and the Philippines, yet the main response has been through providing scholarships in Australia. Another neglected area is local think tanks. While these have played a key role in building domestic analytical capacity, airing policy choices and providing high-quality policy analysis, they appear to be under-resourced given the size of the economies. AusAID's support of the Social Monitoring and Early Response Unit (SMERU), an independent institution for research and public policy studies in Indonesia, is an exception, but this support seems to be tailing off.

Over the past few months, it has become clear that the world may be shifting into a phase of high food prices. The implications of this in Indonesia and the Philippines are apparent in the form of high-cost public subsidies and the exacerbation of poverty. Current support to agriculture is focused on the research activities of the Australian Centre for International Agricultural Research (ACIAR), smallholder agribusiness activities (in Indonesia), and provincial- and municipal-level capacity building (in the Philippines). Yet research is unlikely to yield significant short-term results, and the locally based, community-driven development activities are not sufficiently well integrated into broader national policy. In both Indonesia and the Philippines, agriculture ministries are weak and not yet able to coordinate the range of different agencies engaged in and influencing rural development. This is a potential area for future focus.

### Structural improvements in aid management

Significant changes are necessary for effective implementation of an expanded Australian aid program in Indonesia and the Philippines. Country programs need, however, to invest more in building the 'deep knowledge' of national development issues required to engage on substantive issues, including through better use of locally based expertise. Better methods of tracking progress are needed, including through effective review processes, which demand clearer and more precise objectives. This allows managers to make decisions on results and it provides the information base required to sustain long-term support of organisations. Changes to program governance are also needed, with more scope for Indonesian and Philippine leadership, to allow greater national involvement in formulating priorities and positions.

Both country programs have increased their partnerships with the IFIs in recent years, especially the World Bank. The aim is for Australia to take advantage of the IFIs' technical capacity, policy access and fiduciary controls, while the IFIs benefit from access to Australian grants for technical assistance and capacity building. This makes sense, especially given the current roles and capacities of AusAID and the IFIs. But the IFIs are also looking for substantive partnerships, which require in-house capacity on the part of Australia. Over time, as Australian programs expand, they will be expected to take on more of a leadership role within the donor community and in policy discussions with government officials. This further emphasises the importance of deepening Australia's own knowledge, and managing the political risks and uncertainties that come with a higher-profile aid program.

At the agency level, there are issues around budgeting procedures and personnel rules. In the fluid policy environments that characterise the two countries, opportunities will come and go. Programs need to have the flexibility to expand and contract quickly. Current budgeting approaches do not support this. Likewise, personnel policies do not encourage geographic or sectoral specialisation, and they under-emphasise the importance of local language skills. These will be important in new, larger aid programs in the East Asia region.

## Case studies

This assessment outlines broad conclusions about the future focus of expanded Australian aid. But further in-depth analysis is needed to generate precise guidance on scaling up. Four areas lend themselves to further investigation:

1. An analysis of alternative approaches to working in a decentralised environment. In both countries, Australia has traditionally adopted a regional focus, but is now experimenting with new ways of working on issues of centre-local relations and with progressive local governments. What has been learned about the pros and cons of these approaches, as well as from the approach of other donors to issues of decentralisation?
2. An analysis contrasting the experiences of Australian support to central-level reforms in ministries of finance in Indonesia and the Philippines, including the impact of using Australian Government departments to provide technical assistance and to coordinate with other donors.
3. The support to education reform in the Philippines and Indonesia, including the roles of AusAID and the World Bank in influencing change.
4. Multi-donor trust funds: for decentralisation and Aceh in Indonesia and for Mindanao in the Philippines. This will contribute to a clearer understanding of the potential contribution of these sorts of partnerships to Australia's scaling up in the two countries.

## Issues and implications

### 1 Introduction

The 2007 Annual Review of Development Effectiveness (ARDE) identified concerns around Australia's support to large LMICs such as Indonesia and the Philippines. Specifically, the ARDE asked whether there was clarity around how to deliver aid in these largely non-aid dependent economies. This concern has assumed further importance with the Australian Government's announcement of a possible tripling in size of its aid program.<sup>1</sup>

With significant growth in prospect, an important question is how this additional money can be absorbed. AusAID's ODE undertook this assessment to contribute to the debate around how additional resources can effectively be spent.<sup>2</sup>

The assessment provides a broad overview of the key issues underpinning effective aid to Indonesia and the Philippines. Further investigation is recommended, via a small number of case studies which aim to validate some preliminary findings from this assessment, address specific questions about how an increased aid budget can be spent effectively, and generate precise recommendations about scaling up in LMICs in general.

The fieldwork involved a series of interviews with key stakeholders in Indonesia and the Philippines. A team comprising James Gilling from the ODE, Mark Baird, formerly from the World Bank, and Hal Hill from the Australian National University (ANU) visited Indonesia and the Philippines in April 2008 to conduct the interviews with a small cross-section of stakeholders. Nonetheless, the range of individuals consulted, their influence and insights, and the background knowledge of the team, compensate for some of the shortcomings of this approach. The review was peer reviewed within AusAID and early drafts of this assessment shared with those interviewed.

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<sup>1</sup> Aid spending in 2006–07 was around \$3 billion, a sum representing around 0.3 per cent of Australia's GNI. The Government aims to spend 0.5 per cent of GNI on aid by 2015. Even with conservative growth assumptions, this amounts to an aid program worth more than A\$8 billion by 2015.

<sup>2</sup> In 2006–07, around 30 per cent of the aid program went to the Pacific and Papua New Guinea, 30 per cent to East Asia, and 15 per cent to South Asia, the Middle East and Africa. Questions exist around whether the Pacific and Papua New Guinea will be able to absorb significantly more aid, in part because only around three million of the world's poor live in the region. By contrast, the Philippines and Indonesia together have about 30 million people living in severe poverty, and double this number subsisting on less than US\$2 per day.

This assessment is in three sections. The first summarises key issues and the implications for the Australian aid program. The second provides a detailed assessment of the key issues in the two countries. The third considers in brief options for future case studies.

**Scope:** This assessment identifies common themes about the future role of Australian aid in Indonesia and the Philippines, based on a two-week field trip to both countries. In this way it differs from a typical assessment of Australia's ongoing development assistance program to both.<sup>3</sup> The conclusions from this assessment are aimed at AusAID's most senior managers and at the Australian Government, rather than at the managers of the two country programs. A series of proposed case studies, exploring selected issues in greater depth, should generate conclusions likely to be of more practical value to country program managers.

## 2 Context<sup>4</sup>

### Political and economic features

Indonesia and the Philippines share much in common. They have similar per capita incomes. Their growth rates since 2000 have been similar. Aid flows as a proportion of Gross Domestic Product (GDP) are almost identical. They are neighbours, founding members of the Association of Southeast Asian Nations (ASEAN), and the world's two largest archipelagic states. Within recent memory both have experienced long periods of authoritarian rule and economic growth, which culminated in a deep economic and political crisis—in the Philippines in 1985–86 and in Indonesia in 1997–98. Recovery from these crises has been difficult and painful. Annexes 4 and 5 provide a summary set of social-economic indicators.

The immediate post-crisis similarities are also striking. In both countries, there have been issues around:

- > **Strategic capacity:** National planning agencies such as the national development planning agency in Indonesia, known as Badan Perencanaan Pembangunan Nasional (BAPPENAS), and the National Economic and Development Authority (NEDA) in the Philippines, with responsibility for longer-term, economy-wide development priorities, have been somewhat weakened and politicised. Radical power shifts have also weakened presidencies. Assertive but unpredictable legislatures, bureaucracies seeking to redefine their roles, and vocal but generally unsophisticated civil societies, have resulted in less decisive government. Macro-economic management has been reasonably competent and more or less insulated from political pressures, but micro-economic policy has been highly politicised.
- > **Investment:** Less decisive governments have reduced the attractiveness of policy environments to foreign investors. An uncertain, and sometimes acrimonious, relationship with foreign debtors has further complicated economic recovery—'nationalist' politicians have found the International Monetary Fund in particular an irresistible target. Weak governments with a large debt service obligation and subject to many demands from civil society have found it difficult to invest in long-term projects, with the result that, when growth resumed, severe infrastructure shortages threatened to impede growth.
- > **Fiscal restrictions:** Public debt service absorbs a large proportion of public expenditure in both Indonesia and the Philippines.
- > **Decentralisation:** Decentralisation was rapid and deep in both countries. Particularly in Indonesia, this has resulted in major implementation difficulties, not the least of which are the still-fluid, relative roles, rights and responsibilities between centres, provinces and local governments.
- > **Ethnic tensions:** Post-crisis governments have had to deal with serious ethnic and religious

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<sup>3</sup> ODE undertook independent reviews of the country strategies in the Philippines and Indonesia in 2006 and 2007 respectively: [www.ode.usaid.gov.au](http://www.ode.usaid.gov.au)

<sup>4</sup> This section summarises the more detailed analysis found at Annex 2 of this assessment.

tensions, notably Mindanao in the Philippines and Maluku, Aceh and Papua in Indonesia.

- > **Labour market:** Controls over trade unions have been relaxed, and politicians vie for popularity by supporting unsustainable (and widely flouted) increases in regulated wages. This in turn impairs competitiveness and jeopardises recovery.

Of course, major differences also exist. Historically, the Philippine decolonisation process was benign (although war-time damage was extensive) and its institutions survived intact. It had a major head start in public education and it retains its human capital advantage compared to Indonesia, although this is probably declining. The two countries' export patterns differ significantly, with the Philippines stronger in electronics and remittances and Indonesia stronger in natural resources. Indonesia has grown faster since the 1960s. Its current per capita income is more than five times that of its 1960 level, whereas for the Philippines it is just double. Economic growth under Soeharto had been significantly longer and stronger than under Marcos: 30 years of 4.5 per cent per capita growth, compared to 18 years of around 3 per cent. Indonesia had had the good fortune of two oil booms, and managed them both reasonably effectively, especially in recycling some proceeds into infrastructure and agriculture. Since 1966, Indonesia's macro-economic management had generally been more prudent, except for 1998. Moreover, the country's crisis occurred suddenly, in the midst of strong growth, and with the initial trigger coming from abroad. In the Philippines growth was already slowing down in the early 1980s, and its crisis was primarily home grown.

Indonesia has also recovered more quickly from deep crisis. By 2004, its per capita income had returned to 1996 levels, whereas the Philippines did not recover to 1983 levels until 2004.

Finally, Australia's bilateral relations with the two countries differ significantly. Foreign policy, defence, commercial and education ties with Indonesia are much stronger and there is a larger community in each country with knowledge of the other. Nevertheless, the bilateral political relationship has also been considerably more volatile, particularly on issues related to East Timor and Papua. The United States has traditionally played the dominant bilateral role in the Philippines. This may well be on a downward trend now, creating the opportunity for Australia to play a more substantial role.

### Social features

In social terms, both Indonesia and the Philippines have struggled over the past decade and more to deliver rapid social progress of the type achieved in some of the earlier East Asian success stories (including Indonesia for a quarter century from 1970). This is partly because growth in both has been below these historic norms—for the Philippines since the 1970s and for Indonesia since 1997. Moreover, the policy environment has become less effective in translating even these lower growth rates into improved social outcomes. For example, lower poverty-growth elasticities have been the result of less effective targeting of education and health subsidies and also labour market interventions that have slowed employment growth. Conversely, short-term compensation and food distribution measures appear to have been about as well targeted as could be expected in the circumstances.

The MDGs provide a national level means of assessing progress toward social goals in both countries, but they have their limitations with identifying socioeconomic differentials. In the Philippines, for example, average per capita incomes in the National Capital Region are more than 10 times higher than the poorest region of the Autonomous Region of Muslim Mindanao. In Indonesia, the spread between poorest and richest regions sees Jakarta experiencing average per capita income levels of almost 12 times the poorest province, East Nusa Tenggara. While these inequalities do not appear to be getting worse (in contrast to those in India and China, for example) there is also little evidence that decentralisation policies are reducing inequality. Indeed, weakened fiscal equalisation capacities at the centre jeopardise socioeconomic outcomes in poor and by-passed regions.

## The changing role of aid

Indonesia and the Philippines also share common features with respect to aid (Table 1). Both have a net official development assistance/gross national income (ODA/GNI) ratio of around 0.4 per cent, and are therefore in no way aid dependent.<sup>5</sup> Both are starting to see an increase in the activities of China as a donor. And for both countries Australia is one of the biggest net donors (in 2006–07, Australian assistance to Indonesia was A\$459 million and to the Philippines A\$100 million).

**Table 1: Net Official Development Assistance flows, 2006**

		Indonesia	Philippines	Vietnam	Papua New Guinea	Solomon Islands	East Timor
Net ODA	US\$m	1 405	562	1 846	279	205	210
Net ODA per capita	US\$m	6	7	22	47	410	210
Net ODA/GNI	%	0.4	0.4	3.1	5.5	60.6	24.7
Population	million	223.0	84.6	84.1	6.0	0.5	1.0
GNI per capita	US\$	1 420	1 420	690	770	680	840
Australian aid	A\$	335	71	84	345	240	102

Source: DAC and Australian budget actuals for 2006–07.

As middle-income countries, Indonesia and the Philippines no longer qualify for concessional borrowing from the IDA and the ADF. And while both countries continue to access market-based loans from the IFIs, net disbursements after repayments are expected to be low or negative over the medium term. Indonesian Government policy is to reduce external debt by maintaining negative net flows from official lenders and to demonstrate that it is no longer dependent on IFIs for money and advice.<sup>6</sup> IFI lending to the Philippines is more volatile, reflecting inconsistent policy performance. The Asian Development Bank (ADB) looks as if it will provide lending of around US\$750 million in 2008, largely through program loans. The World Bank is also keen to lend, although slow progress on policy reforms and concerns around corruption reduced actual lending to US\$245 million in 2007–08.

Donor coordination in the Philippines appears to be more effective than in Indonesia, especially following the establishment of the Philippine Development Forum (PDF). The PDF is now the 'primary mechanism of the Government for facilitating substantive policy dialogue among stakeholders on the country's development agenda. It also serves as a process for developing consensus and generating commitments among different stakeholders toward critical actionable items of the Government's reform agenda.'<sup>7</sup> Indonesia abolished the Consultative Group of Indonesia (CGI) in 2007. While it had evolved in recent years toward a co-chaired policy forum with wider participation, it simply lost its relevance and became, in the current political environment, a government liability. In its place, BAPPENAS is establishing a new donor coordination mechanism. This is starting to work in some areas, such as education, poverty and decentralisation, where donor working groups and multi-donor trust funds were already in place. But challenges persist in other areas, such as climate change, where Government of Indonesia leadership is weak and where BAPPENAS struggles to coordinate a large number of actors. More generally, there is a need to strengthen the capacity of BAPPENAS to coordinate aid, especially now that leadership is expected to come from the Government's side.

<sup>5</sup> Note that ODA numbers, as compiled by the Development Assistance Commission (DAC), include official grants and loans with a grant element of at least 25 per cent (at a discount rate of 10 per cent). Market-based lending from multilateral development banks is excluded.

<sup>6</sup> However, in the short run, the Government of Indonesia is looking for additional program loans from the IFIs (and some bilaterals, including Japan and Australia) to cover the widening budget deficit and shortfalls in commercial borrowing.

<sup>7</sup> From the PDF website—[www.pdf.ph](http://www.pdf.ph) This evolution is common as countries move into middle-income status and have less dependency on aid resources and a broader dialogue with development partners, including the private sector and civil society groups.

In the Philippines, day-to-day coordination is usually provided by the NEDA. Concerns exist, however, that the role of the Authority has become more political with recent changes at the top. However, at the technical level, capacity is still largely in place. Therefore, with strong leadership, the NEDA could quickly recover its economic development and aid coordination roles. There is even talk of establishing an independent planning agency, as provided for in the 1987 Constitution. However, it is likely the political environment will remain uncertain through the 2010 elections, and this will inevitably constrain the NEDA's effectiveness. And, if this situation persists much longer, some of the better staff may start to look for careers elsewhere.

### 3 Australian aid

#### **Rationale for Australian aid assistance**

The rationale for providing aid to Indonesia and the Philippines is again similar. Both have significant numbers of people living in poverty, and the poverty incidence is declining rather slowly. Parts of both countries have poverty concentrations, which are high even by sub-Saharan standards (notably in the Autonomous Region of Muslim Mindanao (ARMM), southern Luzon and eastern Visayas in the Philippines and several regions of Indonesia, mainly in the East). To differing degrees, both countries also have severe capacity constraints. The Philippines has a much stronger human capital base than does Indonesia, but this is starting to erode as drop-out rates rise for basic education and higher-level education institutions are run down. Indonesia suffers from many years of institutional neglect and poor quality education. Long-term solutions to these constraints are essential if Indonesia is to address its own problems by improving the policy environment for development and building capacity of the Government, at the central and local levels, and within civil society.

A further rationale is based around a concern to strengthen bilateral and regional stability. In both countries this demands that poverty be addressed. However, it also requires engagement on a range of issues, including anti-terrorism and money-laundering, law and justice sector reform, political development (for example, parliaments, parties, elections), and natural disaster preparedness and management. Long-standing conflicts, especially in Mindanao, undermine development in the southern Philippines and raise broader security concerns in the region. Unfortunately, the prospects for peace remain uncertain, and this inevitably constrains what can be achieved on the development front. But, equally, donors have to be ready to respond quickly—if and when a peace deal is signed.

#### **Characteristics of Australian aid**

In scaling up the aid program, Australia can draw on a number of assets. With the nature of aid, the AIPRD introduced some loans into the Indonesian program. However, experience confirms this was not a positive step, so the program will likely revert to a 100 per cent grant program, as is done in all other bilateral programs, including the Philippines. This provides obvious financial advantages over commercial or non-concessional borrowing, but also simplifies administration, especially when funds are to be channelled through local governments.<sup>8</sup> Australian aid is also now untied, meaning that the countries it contributes to can access the very best goods and services from around the world, thus improving both the efficiency and effectiveness of aid. Australian aid can also be channelled directly to NGOs, without the costs and risks of working through government systems.

A final advantage is Australia's capacity to make a long-term commitment: while other aid programs tend to come and go, depending on the provider's global priorities, Australia's national interest in a stable and prosperous Indonesia ensures a long-term commitment to the country. This allows the aid program to tackle longer-term institutional and capacity constraints and monitor progress over an appropriate timeframe. Such a commitment is lacking at the moment with respect to the Philippines. Australia does not have the same breadth or depth of bilateral relations with the Philippines as it has with Indonesia. Although the Philippine community in Australia is growing—Australian mining firms have interests in the Philippines, and the Australian Government has paid more attention to security concerns in the south

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<sup>8</sup> As a rule, in Indonesia and the Philippines IFIs cannot lend money directly to sub-national governments. Grants, however, can be paid directly to decentralised levels of government (although the Government of Indonesia is trying to rein in this practice).

since September 11—the bilateral ties are much weaker. Similarly, there is a much longer tradition of Indonesian studies and scholarships in Australian universities. There is no reason why these bilateral ties should not expand, especially as the presence of the United States declines. However, it will inevitably take time for Australia to build the level of country knowledge, understanding and presence it has in Indonesia.

### Current program directions

The Indonesian and Philippine programs have seen significant changes in recent years. Both have recently completed new country strategies which reflect their development priorities and expanding Australian aid programs (Box 1). Both have enhanced the roles and capacity of their in-country offices, including by recruiting country economists and working more closely with the IFIs. In Indonesia, the introduction of the AIPRD in 2005 led to a doubling of the program and greater exposure to government systems. At the same time, both country programs are still coming to grips with what it means to be a prominent aid donor in countries where aid does not dominate policy and resource allocation decisions. This requires a deeper knowledge of each country's development challenges, more flexibility to find niche roles and respond to reform opportunities, and new types of partnerships with national/local governments, the donor community, academics and NGOs.

#### **Box 1: Key features of new Indonesian and Philippines country strategies**

Both the Indonesian and Philippines programs have recently developed new country strategies, and there is considerable similarity in their rhetoric. In particular, they both emphasise these types of changes:

- > basing Australian programs around established partner government development strategies
- > shifting away from stand-alone projects and using partner government systems (with appropriate safeguards)
- > engaging with national governments on key policy issues.

The Indonesian strategy, however, reflects deeper thinking about the implications of some of these changes, including by flagging the need to invest in: staff technical and language skills; understanding national and local government systems; and gender equality. It also notes that the program will consider directly funding key Indonesian Government programs.

## 4 Spending more money more effectively

The main institutional, economic, social and political features likely to shape the two countries' aid relationships with Australia to 2015 are, in essence, similar. In the view of the authors, the analysis points to development needs that appear to converge around the linked issues of institution building, strengthening of human capacity, selective support of realistic policy reforms, and some regional focus, particularly to support poor but progressive regions.<sup>9</sup> Newly emerging international concerns around climate change and food security will also influence programming.

Different political realities and the nature of the bilateral relationship with Australia will dictate important differences in how the two programs embrace these areas of focus. In particular, opportunities to support reform in the Philippines will likely be less plentiful than in Indonesia. Concerns about corruption, political interference in decision making, and the lead-up to the 2010 election will likely translate into fewer clear opportunities for Australia to support reforms. Much will depend on the seriousness of the underlying policy dialogue, which may in turn delay progress. In Indonesia, there are also concerns about corruption and the pace of reforms. However, compared to the Philippines, there is more confidence that matters are at least moving in the right direction and are unlikely to be derailed by the 2009 presidential elections.

<sup>9</sup> Clearly, these are broad areas of focus. The authors have not identified specific sectoral priorities beyond those dictated by global concerns, such as food and climate change.

On **institution building**, it is important that both programs learn from past approaches. A heavy focus on the use of foreign technical assistance has often served more to undermine capacity than to build it, and insufficient attention has been paid to understanding the strengths and capacity that already exist. Crucially, inadequate attention has been paid to understanding the underlying institutional incentives that shape the way politicians and bureaucrats behave. Unclear objectives have been adopted, which do not help to implement the long-term programs of support that explicitly recognise there will be ups and downs in any institutional relationship. Tensions with short-term programs of support aimed at accelerating the delivery of health, education and infrastructure services go unacknowledged.

Building institutions in these countries is not a mechanical process. It requires space and flexibility to allow local solutions to evolve. This implies the development of clear and simple frameworks for monitoring progress, which give managers information on what works and what does not, and which give taxpayers confidence that their money has not simply been appropriated and/or forgotten. Most important, it requires clear, results-focused objectives that clearly stipulate the intended achievements.

Building non-government institutions such as think tanks and research institutes will be equally important as strengthening government organisations. Long-term support to such institutions should include the capacity to provide sustained core funding. Instructive examples are available from past AusAID work in the region, notably support provided to Indonesia's SMERU, which should help inform decisions.

The importance of **building human capacity** dominated feedback to the team in the two countries. Specific opportunities seem to converge around a long-term commitment to strengthen the quality of graduates entering the civil service and the private sector. This could mean a more strategic approach to scholarship programs, including a significant expansion in the Philippines (which currently sends only one quarter of the number of students to Australia as Indonesia), and a long-term program of support to overstretched public universities. Here, too, a more imaginative interpretation of the breadth of human capacity issues would lead to a stronger focus on local think tanks and research institutes. These play a key role in building domestic analytical capacity, airing policy choices and providing high-quality policy analysis.

Such are the institutional and human capacity challenges in Indonesia and the Philippines that these two dimensions will be the bedrock of their programs for at least the next decade. But Australia's growing ambitions as a donor create space to support major areas of **policy reform**. The different nature of the two bilateral relationships will influence what is possible in the two countries. In Indonesia, where the two governments have for the most part fashioned a deep, durable and mature partnership, there are opportunities for policy engagement in important and sensitive areas, including in public financial management. The relationship with the Philippines is different and presents unique challenges. A less developed bilateral relationship means that policy engagement in key central ministries is more challenging. Nonetheless, the program has achieved some success in supporting education policy reform.

There is a compelling case for Australia to develop strengthened capacities in policy reform, including through investing in in-house technical capacity and in developing local networks. By investing in local think tanks and research institutes, Australia will develop the capacity it needs to inform its own program—as well as contribute directly to the policy capacity in these countries. To complement a strengthened focus on policy reform, Australia will need to consider under what conditions it is willing to provide quick-disbursing budgetary support and, if necessary, develop the financing mechanisms to accommodate such support. Inevitably, as exposure to local systems is increased, the Australian program will be subjected to much higher risks of corruption. Development of program-specific anti-corruption plans will need to address this issue up-front, including by discussing how inevitable cases of misappropriation will be handled.

Additional money provided by Australia has limited incentive effect at the national level. The story is different with a **regional focus**, where relatively small sums can have a strong incentive effect on progressive local governments. A key challenge here for the Australian program is to ensure coherence between support for local governments and broader programs of support at the national level.

To date, both programs have spent heavily in 'priority' regions, especially Mindanao, Eastern Indonesia and Aceh. Should further spending increases take place, however, the scope for achieving a lot more in these regions, where other donors are also active and absorptive capacity is limited, will come into question. Inevitably, the focus will shift to national programs, issues of centre – local relations, and supporting progressive local governments in other poor regions.

In addition to these core elements of the two programs, emerging international issues will shape future work. Over the past six months, for example, concerns round **climate change** have become central to future programs with all development partners. Nowhere is this more likely to be the case than in Indonesia, whose CO<sub>2</sub> emissions are the third-highest in the world, behind only China and the United States. The overwhelming proportion of these emissions originates in the country's corrupt and largely illegal deforestation. Building on the Bali environment summit in December 2007, there is now global interest in helping Indonesia tackle these long-standing issues, and Australia is engaging through the Global Initiative on Forests and Climate Change. While the scale of emissions in the Philippines is nowhere near as high as it is in Indonesia, climate change issues could be an important aspect of the program. In particular, focus areas might include fragile marine ecologies and major upland erosion.

Chronic concerns around **food security** will also influence programs. The implications of what appear to be structurally higher food prices are apparent in both countries in the form of high-cost public subsidies and the exacerbation of poverty. Current support to agriculture is focused on the research activities of the ACIAR, provincial- and municipal-level capacity building (particularly in the Philippines), and an innovative East-Indonesia based multi-donor approach, the Smallholder Agribusiness Development Initiative. Yet research is unlikely to yield significant short-term results, and, with the exception of the Program Nasional Pemberdayaan Masyarakat and Kalahi, the locally based, community-driven development activities are not sufficiently well integrated into broader national policy.

Increased support for agriculture in the country programs would need to account for the significant shift in agricultural policy priorities that has taken place over the past decade or more in both countries. In particular, the earlier productivity-enhancing investments, such as in rural infrastructure and agricultural extension, have been de-emphasised at the expense of increased price and other interventions, and agrarian reform in the Philippines. Agricultural policy is currently at the crossroads, and whether governments respond to the recent food price increases through increased intervention in markets or longer-term productivity measures will have an important bearing on the scope for productive AusAID engagement in this sector.

## 5 Structural improvements in aid management

The challenges outlined above are all well within the grasp of an expanded Australian program. But effective implementation will require a series of significant changes by the program managers in Jakarta and Manila, and more fundamental changes at the level of the agencies responsible for delivering aid in Canberra.

**Program-level improvements:** Program managers need to invest more in securing the deep knowledge of national development issues needed to engage effectively on substantive issues, including through better use of locally based expertise. Aid management and administration inevitably absorb a lot of staff time. But the sort of program now emerging is conditional upon staff having deep knowledge of national development issues and capacities. At the moment, a great deal of this knowledge comes from working through multilateral agencies, such as the World Bank and the ADB. But as their influence and capacity wane, the nature of these partnerships will change, and Australia will have to do more of the 'hard lifting' directly. Some of this capacity will be in-house. But much will come from engaging with local institutions and experts. Knowing whom to talk to, and having access, will be essential.

Better ways of tracking progress are needed, including through effective review processes. This will allow managers to make decisions on results and provide the information base needed to sustain long-term support of organisations. It is important that improved performance-tracking mechanisms be simple and driven by the information needs of managers. Well-defined milestones, which convey clear, intermediate targets in the face of more substantial overall objectives, are also needed.

Program governance needs to change, with more scope for Indonesian and Philippine leadership, to allow greater national involvement in formulating priorities and positions. Under the AIPRD, a Joint Commission was put in place, overseen by the Australian Prime Minister and the Indonesian President, to set broad strategic directions and agree to major funding priorities. This experience needs reviewing, to learn lessons for the future governance of the Indonesian program. It is probably premature to think of such a high-level formal structure in the Philippines where annual consultations with the NEDA and a

newly created advisory group already operate. However, ways to make these even more effective should be explored.

In recent years, both country programs have increased their partnerships with the IFIs, especially the World Bank. The aim is for Australia to take advantage of the IFIs' technical capacity, policy access and fiduciary controls, while the IFIs benefit from access to Australian grants for technical assistance and capacity building. This makes sense, especially given the current roles and capacities of AusAID and the IFIs. But the IFIs are also looking for substantive partnerships and this requires in-house capacity on the part of Australia. Over time, as Australian programs expand, they will also be expected to take more of a leadership role within the donor community and in policy discussions with government officials. This further emphasises the importance of building up Australia's own deep knowledge, as well as of managing the political risks and uncertainties that come with a higher-profile aid program.

**Agency-level improvements:** At the agency level, changes are needed in several of the basic systems underpinning the delivery of Australian aid. Greater flexibility is important, such that assistance can quickly be scaled up when opportunities arise, and scaled back when avenues for change appear to be closed. For example, Indonesia's Ministry of Finance is driving many reforms in public financial management and civil service reform. Australia has Technical Assistance (TA) in place, and it has contributed to some important reforms (for example, in tax administration). But a more responsive and coordinated approach could make a difference, and hopefully leave in place some institutional changes that would survive future changes in personnel.

A further issue around flexibility is that, faced with the near trebling of its aid program, Australia may lose its capacity to respond to small-scale requests for assistance (up to, say, A\$1 million). Such assistance can have an immediate development impact and also strengthen Australia's presence in-country. It can, however, be a challenge to design selection and monitoring systems that ensure good governance, without overwhelming small-scale schemes. This will be an issue for Australia in many countries—and needs an agency-wide response. A final concern lies with the annual budget process. Where funds need to be cut back quickly (for example, where reform momentum in a ministry stalls) budget managers must find immediate other uses for those funds or return them to consolidated revenue (and risk losing them).

A further agency-wide issue concerns personnel rules. Current personnel policies do not encourage geographic or sectoral specialisation, and they under-emphasise the importance of local language skills. Both are going to be important in new, larger aid programs to the East Asia region, where more substantive technical relationships need to be created both with partner governments and the IFIs. Past policies no doubt reflected the need for flexibility in what was a relatively small overall program. It also reflected the nature of the aid programs of the time. A more modern, ambitious program will need to invest far more systematically in the capacity of staff in Australia and overseas, and take much greater advantage of the excellent skills and experiences available in locally recruited staff.

As donors expand the size of their programs, the tendency has been to suggest that administrative budgets do not need to expand to spend the additional funds. There are clear political advantages in this position, but it ignores the increased complexity of delivering larger programs, which need to be strongly aligned with partner government systems and well harmonised with other donors.

## 6 Case studies

Beyond this assessment, more in-depth analysis is needed to generate precise guidance on scaling up in Indonesia and the Philippines, in particular, and in LMICs in general. Several areas lend themselves to further investigation, in the form of case studies.

The first case study could analyse alternative approaches to working in a decentralised environment. In both countries, Australia has traditionally adopted a regional focus (Mindanao, Eastern Indonesia), but is now experimenting with new ways of working on issues of centre-local relations and with progressive local governments. What has been learned about the pros and cons of these approaches? And what can Australia learn from the approach of other donors on issues of decentralisation?

The second case study could analyse the contrasting experiences of Australian support to central reform in the ministries of finance in the two countries. By contrasting experiences across Indonesia and the Philippines, and by looking at the different modalities adopted, insights will be gleaned on the scope for

more ambitious reforms, on how government-to-government linkages can contribute to better outcomes, and on the challenges of coordinating technical assistance and capacity building activities of different donors.

The third case study could analyse the experiences in Indonesia and the Philippines of central-level education sector reforms. In both countries, AusAID assistance has been part of a strong multi-donor effort, so this case study will analyse, among other topics, how national reform agendas have been shaped by donor support.

The fourth, and final, case study could focus on multi-donor trust funds. Three possible funds will be analysed: the multi-donor trust funds for decentralisation and Aceh reconstruction in Indonesia, and for Mindanao in the Philippines. This will contribute to a clearer understanding of the potential contribution of these sorts of partnerships to Australia's scaling up in these two countries.

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## Annex 1: The development and institutional context

### INDONESIA

#### Introduction

Indonesia is in a state of transition. The economy has recovered from the deep economic crisis of 1997–98 and now appears to be on a growth trajectory of five per cent to six per cent. This is a respectable performance by developing country standards, though slower than the very high-growth Asian economies of China, India and Indochina and also the record of the Soeharto era. This slower growth rate, notably during a period of record commodity prices, is principally the result of a complex process of institutional building and political re-orientation since the crisis.

For most of its 32 years, the Soeharto administration was characterised by:

- (a) strong commitment to economic growth and broad-based socioeconomic progress
- (b) authoritarian rule that allowed only limited scope for civil society, freedom of expression and the development of independent institutions
- (c) high levels of corruption, based around the bureaucracy, the military and the Soeharto family
- (d) reliance on technocratic elite of gifted and committed civil servants who broadly maintained a stable macro-economic environment and a reasonably open economy.

It is impossible to understate the significance of the crisis of 1997–98 and its impact on the country's economy and political processes and community attitudes toward a wide range of issues. Unlike the other East Asian crisis-affected economies, Indonesia in effect experienced 'twin crises'. Its economy contracted by more than 13 per cent in 1998, by far the largest in the region. There was also a temporary loss of macro-economic control and a breakdown in civil order. With Soeharto's exit in May 1998, there was moreover a deep institutional and political vacuum, with no established, smooth-functioning procedures for regime change. For a period, the country's territorial integrity appeared to be under threat. In addition, there was a widespread domestic perception that the international community and institutions had deserted the country at its time of greatest need. Much of this angst was directed toward Washington, both the capital of the United States and the home of two major IFIs.

The period since 1998 has therefore been one of institution building. Indeed, given Indonesia's chequered political history, this has arguably been the first concerted attempt in the nation's 63 years to develop the institutions of a modern democratic state. Institution building in a weak state is a huge undertaking stretching over decades. It is therefore a notable achievement that, thus far, economic growth has resumed and the process has been reasonably peaceful and orderly, particularly with national political processes.

#### The changing policy and institutional context

Since the 1997–98 crisis, the official commitment to rapid economic development and social progress remains. However, the economic policy-making environment has changed fundamentally and with it the capacity of the Government to deliver on these goals. At least nine major changes may be identified. These in turn shape the development policy environment and the role of the international development community.

First is an institutionally weakened presidency, which is subject to a wide variety of checks and balances, an inability to control processes and outcomes in the Dewan Perwakilan Rakyat (DPR), the Lower House of the Parliament of the Republic of Indonesia, and a two-term limit. This is the case even though there is now a process of direct presidential election.

Second is an increasingly powerful, assertive yet unpredictable DPR in which no single party will have the majority voice, and which therefore has to operate through a system of fluid and opportunistic coalitions and negotiating strategies. Moreover, the legislature and executive are institutionally separated and, after

decades of subservience, the former is enthusiastically asserting its will over the latter. Thus government bills and nominations are routinely rejected or modified and cabinet ministers intensively and publicly scrutinised. This realignment of political power and processes is frequently characterised as ‘money politics’. While no doubt accurate, there is also a broader principle of political evolution at stake.

In the case of the current administration, the authority of the DPR over the executive is particularly evident since President Yudhoyono’s Democrat Party has such a small representation. But the principle of DPR independence is likely to apply regardless of particular political configurations.

Third, the cabinet is itself politicised and rarely united. A ‘rainbow coalition’ of political party nominees occupies ministerial portfolios. These ministers are primarily answerable to their party constituencies rather than the President, and their quality is highly variable. A practice has developed since the Habibie administration that a small number of key economics portfolios (together with the defence and foreign affairs portfolios) are assigned to ‘technocratic’ appointees without formal political allegiance. For most of the Susilo Bambang Yudhoyono administration, this principle has been applied to the coordinating economics, finance and trade portfolios. However, there is no guarantee this practice will be maintained.

Fourth, the process of establishing independent institutions within the public sector is slowly taking hold, but the outcomes to date are, as would be expected, highly variable. Thus, there is an independent central bank, Bank Indonesia, which has performed quite creditably. However, its past three governors are all facing serious legal allegations, their movements are restricted, and the bank’s processes are protracted (over a decade in the case of the governor who stepped down in February 1998). The commissions responsible for corruption eradication and competition (known respectively by their Indonesian abbreviations KPK and KPPU) have implemented their mandates vigorously, albeit erratically. Parliamentary involvement in the selection of commissioners has become an issue of public concern.

Fifth, the broader civil society has flourished under its newfound freedom. The press is independent, though vulnerable to payoffs. Media ownership is diverse. The Internet has become a vehicle of vigorous public debate. Street demonstrations have become a daily occurrence. Think tanks of various persuasions and orientations have flourished. Inevitably, the quality of public debate has been highly variable. While there are quality media (for example, Kompas, Koran Tempo, Jakarta Post), most media outlets are populist and sensational. Moreover, almost all think tanks are in reality vehicles for the expression of a particular viewpoint without serious analytical underpinnings.

Sixth, the bureaucracy is a complex and largely unreformed institution that has found it difficult to adjust to the rapidly changing political and institutional environment. For three decades, it was an instrument of, and completely subservient to, President Soeharto. It could ignore the DPR, and it paid little attention to public opinion. Abuses of office were frequent and subject to few constraints. In its internal organisation, there was little connection between the quality of output and reward, promotion was based mainly on seniority, there was little mobility within and between the civil services, and official remuneration scales were compressed, while in practice, earnings varied greatly depending on the opportunity and inclination to engage in corrupt activities.

Little concerted attempt has been made to reform civil service structures and procedures since the crisis, although certain departments (for example, Finance) are now beginning to move in this direction, and independent agencies (for example, BI and KPPU) have a great deal more autonomy in recruiting and managing staff. The role of the civil service in these new institutional arrangements is still evolving. It now has to adjust to the authority of new political masters, with ministerial control and through the DPR. Civil society has assumed a major watchdog function, with almost daily allegations of corruption cases. While greater accountability is to be welcomed, a significant number of corruption cases are politically motivated. Moreover, faced with extremely complex bureaucratic processes, civil servants are increasingly reluctant to resort to traditional (and in some cases quite reasonable) ‘shortcuts’ for fear of corruption allegations. As a result, government expenditure disbursements significantly lag behind commitments, especially for capital works projects involving major tenders.

Seventh, the military remains a key, if weakened, institution. During the Soeharto era, it maintained its ‘dual function’ mandate, as both protector of the state and agent of development. It had a guaranteed presence in the DPR, and was highly influential in certain departments, most notably Home Affairs and, through it, the appointment of provincial governors. It maintained a comprehensive parallel system of national authority and was able to act more swiftly than the civil bureaucracy, especially in times of emergency. Its abuses of power—both human rights infringements and blatant corruption—were little

checked. Senior officers in effect substituted for formal legal processes and companies of any size would retain the services of retired or even serving officers for protection.

The democratic revolution of 1998 has extensively undermined the authority of the Tentara Nasional Indonesia (TNI). Sections of these armed forces were reviled for their civil rights and corruption abuses and, as a result, the TNI lost its automatic right to DPR representation. However, the accommodation between the TNI and the new forces of civil society has been surprisingly swift. The TNI has largely stayed out of politics, unlike in the Philippines where the armed forces were similarly disempowered. Its strengths as a national institution have been recognised, particularly in times of national emergency. Also recognised is that the TNI is grossly underfunded—its official budget is estimated by the current Minister of Defence to be about 30 per cent of its (quite modest) total budget. Hence, there has been something of a *de facto* compact, that the TNI's commercial (and mostly illegal) activities are tolerated, providing it eschews politics and improves its human rights record.

Eighth, the legal system has been historically underdeveloped and the process of judicial reform is, not surprisingly, proceeding very slowly. As noted, the formal legal system was little employed during the Soeharto regime and before. Minor cases came before it, but for any major case there was invariably an extra-judicial settlement. Not surprisingly, the system was unable to resolve the many complex commercial cases that came before it in the wake of the crisis. Judges were poorly trained, legal precedents were limited, and judgments invariably favoured debtors over creditors and domestic over foreign parties. Various attempts to short-circuit the legal logjam have proven to be problematic. For example, arbitration procedures have been resisted, while Indonesian courts have not recognised commercial agreements between Indonesian and foreign parties signed in an overseas jurisdiction.

Finally, Indonesia embarked on a 'big bang' decentralisation program. Two major laws were hastily passed in May 1999—motivated at the time by the fear of territorial disintegration—and implementation commenced in January 2001. Although the country remains an avowedly unitary state, major expenditure authority has been devolved to the approximately 470 kabupaten (districts) and kotamadya (municipalities), effectively bypassing the provinces (now numbering 33) that had been the major subnational unit of authority under Soeharto. Accompanying these changes was the introduction of local democracy, involving progressively the election of both heads and legislatures for more than 500 subnational entities.

This massive undertaking in the world's largest archipelagic state will take decades to complete. Although the framework governing the new arrangements is clear enough in principle, implementation remains a formidable challenge. Resource and personnel transfers from the centre to the region are proceeding, but in some cases slowly. Major coordination issues exist between the centre and local governments, and among the latter. The role of the provinces remains ill defined. As the centre's administrative and financial authority has been weakened, the regions have become emboldened. Some have openly flouted the central government and imposed quasi-legal taxes, often on the flow of goods across kabupaten boundaries. There has been strong pressure to fragment at the subnational level, a process the central government has thus far been powerless to restrict. Thus the number of kabupaten has almost doubled since the early 1990s. Administrative capacity in many regional governments is weak, resulting in large underspending of central government disbursements. Interregional inequality is likely to increase, as the past (crude though reasonably effective) mechanisms for fiscal equalisation are eroded.

### **Post-Soeharto Indonesia: some stylised facts**

In this fluid, evolving environment, what are some of the key stylised facts that characterise Indonesia, and shape its policy directions and development trajectory? A non-exhaustive list (which agencies seeking to engage with these aspects of modern Indonesia ignore at their peril) would include:

- > a country of many policy actors and voices, and therefore a Government often unable to clearly articulate priorities and take difficult decisions quickly
- > a broadly open economy, albeit with continuing ambivalence toward the merits of globalisation, strongly articulated nationalist views, and well developed rent-seeking propensities that exploit these sentiments for personal gain

- > a broad commitment on the part of all major policy actors to essentially orthodox macro-economic policies, as manifested in moderate (albeit high by global standards) inflation and modest fiscal deficits
- > a largely unreformed civil service that, while containing islands of excellence and commitment, struggles with the challenges of running a modern state in a globally interdependent world
- > an underdeveloped legal system, inheriting a legacy of heavily circumscribed judicial independence, and with very limited capacity to supervise a modern commercial economy
- > as a corollary, precarious property rights in the modern commercial sector (related to the underdeveloped legal system) and the household enterprise sector (much of it related to poor land-titling provisions)
- > as a further corollary, a complex and opaque regulatory regime that has remained largely unreformed since the socialist era of the early 1960s
- > a latecomer in educational achievement, with most attention given to meeting quantitative targets directed at the severe backlog in basic education, and in consequence one of the most underdeveloped tertiary education sectors among sizeable Asian countries
- > major achievements in the expansion of physical infrastructure (especially roads) during the Soeharto era, that are now imperilled by: (i) fiscal constraints at the centre; (ii) an inhospitable regulatory and commercial environment for private infrastructure providers; (iii) inadequate coordination between the various tiers of government in the decentralisation era; and (iv) difficulties associated with local-level negotiations over land access for infrastructure
- > enormous regional diversity with respect to natural resource endowments, living standards, institutional capacities, development dynamics and connections to the global and regional economies, with these differences now formally recognised, and arguably accentuated, by the decentralisation program
- > weak natural resource management, including one of the highest rates of deforestation in the world, pervasive illegal mining activities, low-quality urban environmental amenities (for example, resulting from comparatively high vehicle ownership rates, underinvestment in mass-transport systems, limited waste and sanitation disposal systems), and general underpricing of energy resources
- > somewhat unusual ownership patterns featuring, for a mixture of accidental, historical and deliberate reasons, quite high levels of state, foreign and non-pribumi (principally ethnic Chinese) ownership, and also high levels of ownership concentration
- > a mixed and complex picture of inequality: consistently low to moderate household expenditure inequality; higher but poorly documented income inequality; moderately high but (depending on the indicators selected) stable inter-regional inequality
- > variable social outcomes, featuring: (i) a history of generally strong poverty alleviation (owing principally to the growth and expenditure inequality outcomes); (ii) educational outcomes that are impressive with respect to quantitative targets but much weaker on quality measures; and (iii) health and related indicators that are improving much more slowly, which lag behind that of comparable countries in East Asia and exhibit very serious pockets of deprivation
- > high levels of ethnic diversity that have generally been well managed but are a source of continuing tension (and policy preoccupation) in three areas: (i) ethnic Chinese domination of the modern commercial sector; (ii) the intrusion of commercially aggressive ethnic groups into traditional 'frontier' regions with weaker institutional development and educational attainment; and (iii) the administration of religiously diverse regions
- > some major contemporary development issues.

Having navigated the post-crisis period, restored growth rates and returned to (the bottom of) middle-income developing country status, the Indonesian Government is now focused on a range of medium-term development policy challenges. The purpose of this subsection is to briefly highlight some, but by no means all, of these challenges. They are selected on the basis of mission discussions, official documents and the agenda set by the Ministry of Finance for their annual dialogue organised by the ANU together with AusAID and Treasury.

a) **Macro-economic policy:** Indonesia's macro-economic position is now reasonably comfortable. The public debt to GDP ratio is now about one-third of what it was immediately after the crisis. The fiscal deficit in recent years has been less than two per cent of GDP, domestic revenue has been growing significantly (rising four percentage points of GDP over the past five years) and inflation has been in single digits since 1999.

However, major challenges remain. Fuel and other subsidies are unsustainably large, and on current indications (with a world oil price of \$100 per barrel) may total as much Rp200 trillion, or almost one-third of central government expenditure. Inflation is under control, but still three to five percentage points higher than its low inflation neighbours and the Organisation for Economic Co-operation and Development norm. Much remains to be achieved with public-sector expenditure management, and the improved revenue effort is still coming off a low base. The financial sector is immeasurably more robust than it was in the immediate aftermath of the crisis, but remaining fragilities limit the effectiveness of conventional monetary policy instruments.

b) **Climate change and the environment:** This is a new and highly complex development imperative for Indonesia. The Government hosted the December 2007 Bali environment summit, and its environmental footprint is now so large it attracts major international attention. According to various estimates, Indonesia's CO<sub>2</sub> emissions are the third-largest in the world, behind only China and the United States. The overwhelming proportion of these emissions originates in the country's reckless, corrupt and largely illegal deforestation. This has been occurring for decades and shows no sign of abating. If anything, it may have accelerated in the wake of the crisis, as central authority collapsed and new regional actors became involved.

The challenges are formidable, although there is potential for win-win solutions. At least the sources of the problem are well known—deforestation, with subsidised energy prices as a relatively minor second factor (albeit with large macro-economic consequences). The problem is, of course, implementation, even with the best political will. The Indonesian Government currently has no clear line authority in this area. BAPPENAS has coordinating functions, and environment and forestry have direct responsibilities; Home Affairs is involved through its relationship with local governments, while finance, trade and agriculture have interests. The lack of clear policy leadership is accentuated by an acute shortage of domestic analytical capacity, rendering the country dangerously vulnerable to a host of conflicting donor country and international NGO agendas and action plans, some with substantial funding as an additional lure.

Large flows of foreign compensatory funding will be required, alongside the sensitive issue of international monitoring. Local-level development alternatives will have to be found. Accommodation will have to be reached with the now powerful local governments in the resource-rich regions. High commodity prices render the option of deforestation more attractive, as land is cleared for cash and food crops, especially palm oil in recent years.

c) **Poverty:** In the long-term, Indonesia is widely acknowledged as one of the great success stories of the developing world. From the mid-1960s, when Malthusian scenarios abounded, the percentage of the population living in poverty fell from 60 per cent to just over 10 per cent. The crisis and revised benchmarks pushed poverty rates up appreciably, but they have now fallen back to pre-crisis levels. The major explanation for the post-crisis fall in poverty has been the restoration of economic growth. But short-term relief programs, such as free rice and cash transfers, have reportedly also worked effectively.

Here, too, major challenges remain. One is that the administration has (commendably) set ambitious targets for the end of its term, which is now virtually impossible to achieve due to rising food prices. A second is that the principal mechanism for converting growth to poverty reduction—the provision of employment opportunities outside the subsistence sectors—is now working much less efficiently, owing mainly to the introduction of regulatory measures discouraging employment growth. Third, although

poverty rates have fallen, a substantial proportion of the population (as much as one-third) are 'near poor' and remain vulnerable to a sudden change of circumstances (loss of employment, illness, a rise in the price of staples) that could push them below the poverty line. Fourth, the nature of the poverty challenge varies across regions. Poverty incidence correlates closely with per capita income and thus the highest rates of poverty are generally—though not exclusively—found in the poorer regions of Eastern Indonesia. However, the greatest number of poor people is still found in Java, and thus regional development strategies must adopt a nuanced approach to the problem. Fifth, as poverty rates fall, the remaining poor are increasingly categorised in what is sometimes referred to as 'hard-core poverty', that is, elderly, sick, poorly educated, regionally isolated people, for whom such broad strategies of growth, employment creation and education may have little impact.

d) **Regional development:** The regional dimensions of economic development matters for Indonesia, arguably more than any other AusAID partner country. Regional disparities are very large, with the per capita income of the richer regions more than 10 times that of the poorer ones. Social disparities are also significant. Remarkably, and uniquely among the developing world's most populous nation states, these disparities have not increased over the past 30 years. However, the development trajectories of the country's regions vary greatly. The regions that are better connected to the global economy—Jakarta, Bali, the Riau Islands, North Sumatra and parts of Kalimantan—are generally growing faster than the rest of the nation. To preserve its territorial integrity and achieve a measure of balanced spatial growth, the central government has to be heavily involved in regional development strategies.

This challenge is, of course, occurring against the backdrop of the country's ambitious decentralisation program and the rapidly evolving centre-region relations. The Government has less capacity—administrative, political and financial—to influence regional development patterns. The technical challenges associated with decentralisation—the division of expenditure authority and revenue raising and the maintenance of vertical and horizontal balances—have to be managed in the context of increasingly independent-minded regional governments which at times—especially in taxation and environmental management—act contrary to national development priorities.

e) **Micro-economic policy and infrastructure:** Since 1998, micro-economic reform has proven to be more complicated and slower than macro-economic stabilisation. It has also been the area where policy coordination has been the most difficult, as newly empowered ministries such as labour, agriculture, industry and state enterprises have sought to develop a more interventionist approach to industry policy. The familiar political economy reasons explain these outcomes: the range of actors is large; the beneficiaries of intervention are concentrated while the opponents (especially consumers) are diffused; there is greater political agreement on the need for 'orthodox' macro-economic policies; and the crisis and its aftermath emboldened the proponents of various interventionist schemes.

Indeed, the only policy anchor of any significance is that the economy has remained broadly open, providing an overall discipline on policy making. For example, trade policy has become a more contested field. The gradual appreciation of the Rupiah, largely for 'Dutch disease' reasons, has encouraged the line ministries' natural propensities for intervention, combined with the need to fund political party campaigns. Unattractive labour regulations have also resulted in increased pressure for protection. The division of policy responsibility has also complicated these outcomes, with finance, which maintains responsibility for tariffs, able to resist pressure for increased protection, but the line ministries increasingly resorting to non tariff barriers, where they have greater responsibility.

Regulatory and licensing reform is another area in which progress has been difficult although the 2006 Investment Law is now being implemented.

## THE PHILIPPINES

### Introduction

The past few years have been unusually favourable for the Philippine economy. Growth is at historically high levels, at six per cent to seven per cent per annum, and it has been continuously positive for the longest period in the country's history since the 1970s. Inflation is in check and the stable monetary policy framework now appears to be durably embedded in the country's political economy framework. Public debt remains very high, but the fiscal deficit is now very modest, and revenue and GDP are rising. This has all been achieved in the face of continuing political uncertainty and terms of trade that have been deteriorating since 2000.

The boom and bust growth patterns of the past, reflecting the combined effects of adventurous macro-economic policy and political instability, appear to have moderated, perhaps reflecting also the fact that the business community has learned to adapt to the regular bouts of political uncertainty. The growth record has been driven fundamentally by the major reforms of the 1990s, from which there has been no major backtracking. These reforms included the establishment of an independent central bank with a clear assignment of responsibility for inflation control, significant trade liberalisation, and a range of micro-economic reforms.

Notwithstanding these achievements, the Philippine development reform agenda remains daunting for these reasons:

- > The fiscal policy framework is precarious. Fiscal deficits have been moderate in recent years principally through the short-term, emergency expedient of a severe compression of public expenditures. The public sector has been starved of resources, resulting in a poorly remunerated and demoralised civil service, the underprovision of growth-enhancing public expenditures (especially infrastructure), and very limited provision of social expenditures for the poor.
- > Savings and investment remain very low by East Asian standards, hence constraining future growth potential and indicating that the business community requires further reassurance.
 

Since 2000 the pace of micro-economic reform has been sluggish, compared to the country's achievements in the previous decade and the higher growth East Asian neighbours.
- > Economic growth is only weakly delivering improved social conditions. Poverty is not particularly responsive to growth; education and health indicators are barely improving for lower income groups; and many poorer regions—not only in Mindanao—are growing slowly.
- > International migration and remittances are now a major driver of growth, more so than in any other East Asian economy. While the majority of migrants and their families benefit from the decision to go abroad, the phenomenon raises broader development policy concerns, including the inability of the labour market to translate growth into employment expansion at home, the loss of human capital, some adverse social consequences, and perhaps a diminished determination in the Government to press on with the domestic reform agenda.
- > This section of this assessment examines these issues against the backdrop of the country's policy and institutional context, its longer-term development trajectory, the state of the bilateral relationship and some key contemporary development policy challenges. The final subsection compares and contrasts Indonesian and Philippine economic development issues.

### The policy and institutional context

The Philippines experienced a deep economic and political crisis in 1985–86, quite similar in origins and consequences to that of Indonesia in 1997–98. The Marcos administration was overturned after 20 years of mostly authoritarian rule, the economy contracted by more than 14 per cent and there was a temporary loss of macro-economic control. A new Constitution took effect from 1987. The central government's authority was greatly and deliberately weakened in an institutional sense by this Constitution, in addition

to the political vacuum created in the wake of the collapse of the Marcos rule and the diminished fiscal resources at the disposal of the new administration. A major decentralisation program was introduced in 1992.

The Philippine Constitution prescribes clear roles for, and a division of authority between, the executive and the legislature. The candidate who receives the greatest number of popular votes is elected President for one 6-year term. There is no guarantee, and in fact it is generally unlikely, that the Vice President will be from the same political party or that the President's party will have a majority in Congress. A small number of veto players—for example 12 members of the Senate—can block key legislation, including the budget. Indeed, since 2000 central government budgets have been blocked with alarming frequency, resulting in a semi-permanent political paralysis and a severe depletion of public-sector resources.

Nevertheless, in spite of the institutionally weakened presidency, the power of the Office of the President is considerable. Malacanang is involved in all major appointments to the civil service, judiciary, the diplomatic service, and a host of quasi-government institutions. Moreover, the discretionary budget of the President is large and growing over time. Ironically, blocked budgets and the subsequent release of 'frozen funds' are allocated by the President and do not necessarily correspond to national budget priorities.

Four additional factors complicate political processes. First, election results at all levels of government are invariably disputed and contentious. Legal and extrajudicial challenges may persist virtually through the life of an administration, thus tarnishing its image and diminishing its political authority and moral legitimacy. Second, political and financial scandals are seemingly an everyday occurrence in Philippine political life and they have the capacity to seriously distract a government. Third, the relationship between the executive and the judiciary is uneasy. 'Veto players' are important and numerous. The role of the Senate is particularly important in this respect: although it takes 12 Senators to block legislation, a single Senator can be significantly obstructive. Fourth, the military continues to be an important political player. Since 1986, there has only been one change in administration outside the normal political process, and military coup attempts are becoming less common. However, governments must consider the possibility that a restive military could undermine democratic processes, resulting in senior military officers exercising disproportionate authority.

For all these reasons, politics in the Philippines is unusually fluid, governments frequently lack legitimacy and time horizons are short. A similar set of factors operates at the subnational level.

This political unpredictability is compounded by a weak and politicised bureaucracy for three reasons:

- > Senior echelon appointments are the prerogative of the President. This includes the positions of secretary, under-secretary and assistant secretary, and sometimes even director level. In consequence, there is high turnover at senior levels and a lack of institutional memory.
- > Civil service compensation has been severely squeezed in recent years, with the result that the service is an unattractive career proposition for talented young professionals. The service is able to attract talent at the senior, political levels, for those interested in policy and political power, but the permanent civil service at middle and lower levels has lost much talent in recent years.
- > The structures and organisation of the civil service are not conducive to a modern professional service. Promotion is mainly based on seniority; there is limited mobility within the service, and between it and the world of business, academia and civil society; professional development is insufficiently emphasised; and there is overstaffing.

In addition, the country lacks a core group of what may be termed 'technocrats'—essentially non-political senior economists with extensive policy experience on whom an incoming administration may rely. In this respect, the Philippines differ from Indonesia and Thailand. Moreover, the informal consensus that the positions of Director General of the NEDA and Secretary of the Department of Finance would be decided principally on technical grounds appears to be eroding.

But the system also has its strengths. The press is free and among the quality outlets arguably the best in the ASEAN. Civil society is boisterous and includes some quality. The widespread linguistic proficiency in English has resulted in stronger international connections and awareness than in many of the country's neighbours. The top universities are still among the best in the region, and their graduates feed into government and civil society. Notable here are the national University of the Philippines, though its

financial position has become increasingly parlous over the past decade, and the better private universities such as Ateneo and De La Salle. At the margin, the 10 per cent of the population who reside abroad temporarily or permanently are among the forces pushing for higher quality of governance.

### **The Philippines: some stylised facts**

The Philippines is a middle-income developing country with a per capita income of about US\$1300. Viewed in the comparative East Asian context, the major stylised fact is that it is an 'outlier'. Specific features include:

- > The country's development indicators have improved more slowly than in most East Asian states. In the 1950s, its per capita income was above Korea, Taiwan, China and Thailand, yet all of these high-growth economies now have significantly higher per capita incomes. The comparison with Thailand is particularly pertinent: it has (or had) a similar size, population, natural resource endowments and location. In the 1950s, Philippine per capita income was about double that of Thailand, whereas today the reverse is the case.
- > This comparative ranking reflects both slower long-term growth and the disastrous decade of the 1980s, when most of East Asia grew strongly. During the 1990s, Philippine economic performance was increasingly robust, and it was much less adversely affected by the 1997–98 economic crisis (owing to a combination of good policy and some luck). Since 2000, per capita growth rates of Indonesia, the Philippines and Thailand have increasingly converged, within the range of three per cent to five per cent.
- > Moreover, the country has never achieved very high growth, in excess of eight per cent, as experienced for decades by Japan, the four Newly Industrializing Economies and China, Malaysia and Thailand occasionally, and India and Vietnam more recently. Savings and investment have rarely exceeded 20 per cent of GDP since the mid-1980s crisis, while international financial sources do not permit the country to run current account deficits of more than three per cent of GDP. Estimates of total factor productivity growth suggest rates well below the East Asian norms.
- > Nevertheless, there have been significant and durable policy reforms since the 1980s. Some foundations were laid during the Aquino administration (1986–92) in the wake of the crisis, while the pace accelerated under the reformist Ramos administration. The two most important reforms have been those relating to trade policy and the establishment of an independent and credible central bank, the BSP. These reforms have been central to the country's stronger growth rates since the early 1990s and its ability to weather financial and political shocks. The adoption of a floating exchange rate has provided the 'shock absorber' that has enabled the economy to survive crises that, in earlier times, would have resulted in negative growth.
- > The Philippines is a high inequality country. Like Malaysia, this has its origins in highly unequal land ownership patterns from the colonial era. The gini ratio for household expenditures has been consistently high, in the range of 0.45 to 0.5, and shows no long-term trend. The distribution of wealth is poorly measured, but is similarly very high. There have been no serious attempts to reverse this high inequality, apart from a largely ineffectual agrarian reform program. It should be noted, however, that neighbouring countries are catching up to the country's high inequality—China may have already overtaken it—and that attempts to ameliorate historically embedded inequality are rarely successful.
- > By contrast, social indicators present a more favourable picture. The country inherited comparatively good educational outcomes from the late colonial era, health outcomes are comparable with countries of similar per capita income, and gender disparities are among the lowest in Asia. This advantage in social outcomes is eroding, owing to lower growth and poorly targeted social expenditures. Health and education outcomes for the bottom four-decile income

groups are of particular concern. Nevertheless, the country still retains an advantage with its large numbers of well-educated, English-speaking tertiary graduates, as indicated by its success with service exports and overseas workers.

- > The Philippines is the world's second-largest archipelagic state. Its unusual geography has resulted in highly diverse spatial patterns of ecology, ethnicity, economic activity and economic performance. It is sometimes regarded as difficult to govern. Economic activity is highly concentrated around Manila and surrounding regions, which account for about 60 per cent of GDP. Manila's per capita income is almost three times the national average and about 10 times that of the poorest region, the ARMM.
- > Although it was the first East Asian state to undertake democratic decentralisation, the Philippines remain a unitary state and a somewhat reluctant decentraliser. The central government, and particularly the presidential office, continue to be powerful and intrusive, and continue to control the finances of all but the wealthiest regions. The shares of subnational expenditures and revenues are low by East Asian standards.
- > In terms of regional development dynamics, there have been no major changes in subnational rankings over the past two decades, in spite of the 1992 decentralisation program. In general, the more dynamic regions have stronger connections to the international economy, including Manila and surrounding regions, greater Cebu (the second city and capital of the southern regions) and resource-rich regions that are largely conflict-free, such as northern Mindanao. Entrenched poverty remains a serious problem most of all in the ARMM, with southern Luzon and the eastern Visayas also regions of endemic poverty.
- > The Philippines has one of the highest population growth rates in East Asia and a much slower demographic transition toward low fertility and mortality. Since the 1970s, the population growth has slowed from about 3.5 per cent per annum to 2.1 per cent. Religious opposition from the dominant Catholic Church and slower economic development explain these outcomes. Family life surveys report that, for most women, the actual number of live births exceeds the desired number. Contraception and family-planning advice are not widely available, particularly to poorer households.
- > As a consequence of slow economic growth, reasonably good education, widespread English proficiency and established labour export channels, the Philippines is a major labour exporter. Approximately eight million Philippine citizens reside abroad and remittances total almost US\$20 billion, equivalent to almost half of merchandise exports. The country's remittances are the fourth-largest in the developing world, after China, India and Mexico.
- > Also as a consequence of rapid population growth, population densities are high, and the country is in transition from relatively resource-rich to resource-poor status. The latter is exacerbated by continuing conflict in relatively resource-rich Mindanao.
- > Philippine exports are unusual in two respects. First, merchandise exports are highly concentrated in electronics and related machinery and equipment goods. These now total about 80 per cent of exports, the highest proportion in East Asia. The country is therefore connected to international production networks in these rapidly growing export sectors, albeit at the low end, with a narrow export specialisation, and originating mainly from enclave export zones. Second, the country has growing export success in services, including call centres, back-to-office services and health services. In developing Asia, the country is second only to India in these fast-growing segments. More generally, the economy is becoming increasingly services-dominated, with the share of agriculture and manufacturing declining since the 1980s.
- > The Philippines continues to be a relatively high-conflict country. Western Mindanao and the islands in the Sulu Sea have experienced serious conflict for decades, interrupted by a series of short-lived peace agreements. The ARMM region is thought to be a significant incubator of terrorism in Southeast Asia. Conflict in other areas of the country, associated mainly with the

New People's Army, continues, albeit at lower levels. In addition, the country is considered to be one of the more dangerous locations for journalists and election-related fatalities. Gun ownership levels are high and personal levels of security are below East Asian norms.

- > The Philippines has a highly developed legal code and active legal processes. Its leading lawyers are regarded as among Asia's best. In general, the legal system has been more effective in protecting human rights than in overseeing a smooth and effectively functioning system of commercial law. The country is a highly litigious society, and legal disputes are often lengthy owing to the appellate system. Many commercial disputes therefore do not enter the formal legal system.
- > Two features dominate Philippine external relations. The first is the continuing dominance of the United States in commerce, strategic affairs and society. More than for any other East Asian country, the United States remains the country of choice for migration, tourism and education, bolstered by an estimated Filipino community numbering around five million. Second, although it is a founding member of ASEAN, the country is arguably less integrated within the region than any other member country with the exception of Myanmar. This applies not only to its commercial patterns but also to education and people-to-people contact.
- > As a corollary, Australia's commercial and political ties with the Philippines are weakest among the six major ASEAN economies. Historically, both countries have tended to look past each other. The slower growth of the Philippines and its reputation for political instability has tended to deter Australian business. Moreover, the major Australian investment is in mining, which remains contentious in some quarters. Defence cooperation between the two countries is rising quickly, although it does not register in the wider bilateral relationship. Strong educational ties, and associated tourism flows—connecting Australia with Indonesia, Malaysia, Singapore and Thailand—are only weakly present for the Philippines, owing to the elite's overwhelming orientation toward the United States, combined with the presence of several international quality local universities. Academic, media and cultural ties between the two countries are also weak. On the positive side, the Philippines is typically the largest source of migrants to Australia from Southeast Asia, and the church connection between the two countries has always been significant.

### **Some major contemporary development issues**

This section briefly outlines several key development issues and challenges in the Philippines.

#### **a) Poverty and the growth-poverty nexus**

There are four distinguishing features of poverty in the Philippines. First, it has declined moderately from the mid-1980s crisis, from around 40 per cent of the population to around 25 per cent. Second, poverty reduction has been less responsive to growth than in most other developing Asian economies. That is, poverty-growth elasticity has been a little more than unity, in contrast to figures of around two for its neighbours, notably Indonesia, Thailand and Vietnam. Combined with slower growth, this has resulted in a significantly slower poverty decline than in most of East Asia. Third, poverty is highly variable across regions, with the incidence of poverty in the poorest region (ARMM) is more than 10 times that of the richest (Metro Manila). Nevertheless, intraregional inequality is greater than interregional inequality, and thus regional development projects on their own are a somewhat blunt anti-poverty instrument. Fourth, the household and individual correlates are broad, as would be expected, with education, access to land and markets, and location being among the principal determinants.

Social indicators display less variation across regions and income groups, but are nonetheless significant. Although the country historically had quite a good system of public education, and education was not decentralised as part of the 1992 changes, the evidence suggests that education outcomes are becoming more unequal over time. This is principally related to the rise of good quality, fully private education alongside a deteriorating public system. In the case of the latter, there are reportedly large variations by region and income groups, with dropouts occurring even at the primary level, especially among poor rural households. Incentives to ensure school completion through at least until mid-secondary school therefore are thought to have high social payoffs.

Inequalities in the case of health outcomes are higher. The public system is much weaker, and government subsidies have been less effectively targeted. Health was decentralised in 1992 and poorer regions have been unable to maintain public services. There has also been a large loss of nursing staff abroad, and only the top-end private sector is able to compete internationally for these mobile nurses.

Philippine poverty and social statistics are moderately satisfactory. In the case of poverty analysis, a panel dataset based on the three-yearly Family Income and Expenditure Series (FIES) has been maintained by Professor Arsenio Balisacan and his graduate students. These also have the attraction that they incorporate regional price differentials and allow for administrative boundary changes, thus enabling comparisons over time and across regions. But the FIES data suffer from various shortcomings, including significant understatement of income and expenditure, three-yearly intervals, and slow processing and release of data. A high priority for the Philippine Government and the donor community should be better quality and more timely data.

#### **b) Macro-economic management**

Philippine macro-economic management has been much improved since the 1985–86 crisis. Inflation has generally been moderate and the country has not experienced a single balance-of-payments crisis, unlike the earlier period when economic booms or large negative terms of trade declines regularly resulted in crises and recessions.

The central bank, the BSP, was completely reorganised in the wake of the crisis and created as an independent entity with a clear objective of low inflation. It has succeeded in this goal since the early 1990s, remarkably in view of the earlier history of political intervention and mismanagement, and in the context of occasionally loose fiscal policy, frequent political instability and large exogenous shocks. In essence, the exchange rate has become the shock absorber, largely insulating the real economy. Improved financial sector management has in turn meant that, unlike in the past (and also elsewhere during the 1997–98 Asian economic crisis), significant exchange rate depreciations have not resulted in a financial crisis. The BSP is a telling indication of how institutional reform within the public sector can be achieved given the requisite political will.

Fiscal policy has been more problematic. During the Ramos presidency, the country achieved the rare feat of three successive fiscal surpluses. These turned to deficits during the 1998 slowdown, and since 2000 the Government has been almost continuously grappling with a serious fiscal deficit, principally because the Senate was able to block key revenue-increasing measures. The Government ensured that the declining revenue effort did not translate into a fiscal crisis only through the ruthless suppression of expenditures, resulting in the serious underprovision of public goods and hence growth prospects. Since 2006, government revenues have risen, and the deficit (and hence public debt as a proportion of GDP) has fallen quite sharply. However, the backlog in public expenditures remains serious.

#### **c) Micro-economic reform and infrastructure**

Several features of the environment for micro-economic reform warrant comment.

The first feature, on the positive side, is that the Philippines has been largely transformed from a highly protected and inward-looking economy in the 1950s and 1960s to a largely open economy. Most quantitative restrictions outside agriculture have been removed, while both average tariffs and their dispersion have declined significantly. Many industrial exporters effectively operate on a free-trade footing by locating in a zone operated by the Philippine Export Zone Authority. It is impossible to understate the importance of these reforms. Combined with the floating exchange rate and removal of capital account restrictions, the commercial policy environment of the country has been fundamentally transformed.

Moreover, major deregulations of telecommunications, inter-island shipping, domestic civil aviation, finance and other sectors existed, especially during the Ramos administration. By and large, none of these reforms has been subsequently overturned. The remaining reform agenda is substantial, however.

A third feature is that the country's regulatory environment remains complex. It ranked 126 out of 175 economies in the World Bank's Doing Business 2007 survey and had a ranking in excess of 90 for all major areas except trading across borders (63) and enforcing contracts (59). Here, the reforms have been much slower, with little progress since the Ramos era.

A fourth feature is that, notwithstanding their success, the export zones have introduced a dualistic policy environment, with firms inside them facing much simpler regulatory requirements, in addition to free

trade and fiscal incentives, while outside firms operate in a much more difficult environment. This dualism is, of course, an artificial policy construct, and the principal challenge for policy makers is to extend the major export zone reforms (except arguably for fiscal incentives).

A fifth feature is very high ownership concentration in the modern commercial sector, reflecting in turn the country's high level of wealth concentration. This concentration is, of course, historically deep-seated, and not easily amenable to policy reform. But it highlights the imperative of an open trade regime as a competitive discipline on tradable goods industries, and regulatory reform and reduced barriers to entry across all sectors.

Thus while reform is difficult—owing to the significant number of legislative (and sometimes judicial) veto players and the widespread capture of the bureaucracy—it is not impossible. The open nature of Philippine society and public debates means high-quality analytical research on key policy issues can force policy reform. This is especially the case when the key actors are identified and their interests accommodated or neutralised.

On infrastructure, reform has also been slow, and the country has historically underinvested. Currently, its infrastructure investment as a proportion of GDP is about half the East Asian average, with roads, harbours and airports being significantly deficient.

Four factors explain the underinvestment. First, continuing near fiscal crises has resulted in a sharp contraction in the Government's investment program. Second, political uncertainty and regulatory risk deter private investors who require a clear, non-political, long-term environment in which to undertake such investment. That many major infrastructure projects—power plants, toll roads, airport facilities—have become mired in political and legal disputes is a major deterrent to international infrastructure investors. Third, the 1992 decentralisation program assigned national infrastructure (for example, national highways) to the central government, and local infrastructure to local governments. In this sense, there was a clear assignment of responsibilities. However, a 'missing middle' has emerged with the provision of intermediate roads, connecting the national and local systems, and this is reportedly hindering the efficient operation of agricultural marketing chains. Fourth, the process of building major infrastructure projects has become complex and politicised, especially owing to disputes over land acquisition and compensation for local communities.

#### d) **Regional development dynamics**

As noted, the Philippines was the first country in East Asia to implement a program of 'democratic decentralisation', and the system is now fully operational. The country remains a unitary state, but the local government units (LGUs) have a number of administrative and financial responsibilities. Administratively, there are 17 subnational regions, but except for the ARMM none of these has administrative authority. Effective local authority resides with the approximately 79 provinces and 28 'chartered cities', in addition to municipalities and 'component cities', plus at the community level around 42 000 barangays.

The principal general observation to make is that the decentralised system is functional. To varying degrees, the central government and the LGUs have pragmatically devised an operating system that broadly delivers a wide range of services. A number of specific features deserve attention. First, although in principle the division of powers and responsibilities among the various tiers of government is clear, in practice the central government has a propensity to intervene in LGU affairs in a random and unpredictable manner. Second, the central government's fiscal problems have been transferred to the LGUs, automatically through reduced grants and indirectly through arrangements designed to conserve Manila's resources. In addition, designated central government in some departments (for example, agriculture) have still not been transferred to the LGUs. Third, the resources transferred to the LGUs remain modest in aggregate. Their expenditure amounts to just 3.3 per cent of GDP, much less than is the norm for decentralised regimes. Fourth, and in part owing to the factors noted above, the system does not yet operate according to the textbook principles of federalism. That is, while local governance quality varies considerably, with some clear cases of both excellent and poor administration, there is no evidence yet that well-governed regions are being rewarded with a 'reform dividend' of footloose factors migrating in, and hence recording higher rates of investment and growth. It may be that the system is still in

transition toward such outcomes or, more likely, the powers of the LGUs are so limited, the propensity for central government intervention so substantial, and the quality of LGU governance so variable (that is between administrations, as with the national level), that these outcomes are unlikely to be observed.

Thus, in sum, for such a spatially and socially diverse country, the decentralisation program was no doubt desirable, but its effects on regional development dynamics and governance have been rather limited. The wealthier and poorer regions of today are broadly the same as in the 1970s, when regional socioeconomic statistics first became available. There are perhaps two exceptions to this generalisation: first, the socioeconomic position of the conflict-affected ARMM region has further deteriorated relative to the national average; and second, while the regions most connected to the global economy—Manila and surrounding regions, Cebu, and selected export zone regions—have drawn further ahead.

#### e) **Natural resource management and climate change**

As noted, rapid population growth has transformed the Philippines from a resource-rich to a moderately resource-poor country since independence. Moreover, there has been a severe depletion of its natural resource endowments. Its forest reserves are now largely removed, except for outlying regions such as Palawan and parts of Mindanao. The country's marine ecology is fragile and overused, while many parts of its oceans are severely overfished. Its mineral resources have been much less exploited, owing principally to the two-decade shutdown of mining after the 1985–86 crisis.

The country is now the world's largest rice importer, and thus in 2008 the Government has been highly focused on food availability and prices. Historically, the Philippines has slid from being largely food self-sufficient to being a net importer. This fundamentally reflects comparative advantage, particularly the rapidly declining land-labour ratios. The country hosts the International Rice Research Institute and in the 1960s and 1970s it was an early adopter of the new high-yielding rice varieties. However, agricultural productivity growth has been negligible since around 1980. The policy regime has contributed to this outcome. Investment in productivity-enhancing inputs—roads, irrigation and extension services—has declined. Price intervention through the National Foods Authority has had perverse effects. Agrarian reform has created tenure uncertainty and therefore deterred longer-term investments. Conflict in Mindanao has reduced the scope for expansion into the agricultural frontier regions.

The Philippines has an obvious interest in global climate change issues, but unlike Indonesia it is not a major actor. Its carbon emissions are low, reflecting its low per capita income, the process of deindustrialisation that has been underway for the past two decades (and the concomitant rise in generally lower-pollution service-sector activities), and the fact that deforestation has been largely exhausted.

One final and general observation on economic policy and reform is pertinent. As with education in general, the Philippines had an early lead in the field of economics education. With generous international assistance, the University of the Philippines emerged in the 1960s as the strongest economics department in Southeast Asia, with an international quality faculty and a strong teaching program at undergraduate and master's levels. The School of Economics trained most of the economists in government and public policy institutions over this period, and for the next quarter century. It has continued to be the principal incubator of high-quality economic policy discussion in the country, and at several major junctures in the country's history it has issued high-profile 'white papers' on economic issues of national importance.

It spawned the Philippine Institute for Development Studies (PIDS) in the late 1970s as an arms-length policy-oriented centre within government, and that institution too became the finest of its kind in the region. The PIDS is particularly important as it connects both to major East Asian economic policy and research centres and to a local network of such institutions throughout the country. The school and the PIDS publish respectively the country's leading economics and development policy journals. Although it is not widely appreciated (especially within the international donor community), the resources of both have been seriously run down since the late 1980s. International donor support has largely disappeared, while the large decline in real public-sector wages has rendered conditions of employment in these institutions increasingly unattractive. If the donor community, which draws substantially on their resources, wishes to contribute to the maintenance of high-quality local institutions in the field of public policy, the School and the PIDS are clearly worthy recipients.

## INDONESIA AND THE PHILIPPINES: SIMILARITIES AND DIFFERENCES

This assessment has thus far examined Indonesia and the Philippines separately. This section concludes with an integrated discussion of the similarities—and a few of the differences—between the two countries.

Indonesia and the Philippines share much in common. They have similar per capita incomes. Their growth rates since 2000 have been similar. Aid flows as a proportion of GDP are almost identical. They are neighbours, founding members of ASEAN, and are the world's two largest archipelagic states. Both countries have at times been written off. The late Professor Benjamin Higgins once referred to Indonesia as a 'chronic economic dropout', while the Philippines is often termed the 'East Asian exception' because of its sometimes-lacklustre economic performance.

Presidents Marcos and Soeharto came to power in the same year, 1966. Both promised an emphasis on accelerating economic development and both brought several bright young professors into their administrations as apolitical technocrats. Both fell from grace ignominiously—Marcos in 1986 and Soeharto in 1998.

Perhaps most important of all, within recent memory both have experienced long periods of authoritarian rule and economic growth, which culminated in a deep economic and political crisis after which recovery has been difficult and painful. The Philippine crisis occurred in 1985–86, 12 years earlier than Indonesia's. There were many similarities in the pre- and post-crisis periods. The economic contraction was deep, about 14 per cent in each case, albeit spread over two years in the Philippines, but just one in Indonesia. In both cases, short-term capital flight caused the exchange rate to collapse, in turn exposing financial fragilities. There was also the conjunction of economic and political crises. In both countries, there was comprehensive and relatively sudden regime collapse, creating a power vacuum.

The post-crisis similarities have also been striking. In both countries there has occurred:

- > Radical power shifts, with a weakened presidency, a newly assertive but unpredictable legislature, a bureaucracy having to redefine its role, and a noisy but generally unsophisticated civil society—all of which resulted in indecisive government and an unattractive investment climate.
- > A divide, which emerged between reasonably competent macro-economic management, more or less insulated from political pressures, alongside highly politicised micro-economic policy.
- > Fiscally incapacitated government, with public debt service absorbing a large proportion of public expenditures.
- > An uncertain, and sometimes acrimonious, relationship with foreign debtors, further complicating economic recovery. 'Nationalist' politicians have found the IMF in particular an irresistible target.
- > A weakened centre, in response to pressure to extend democracy and fiscal authority to the regions too quickly, particularly in Indonesia.
- > Populism in the labour market. Controls over trade unions have been relaxed, and politicians vie for popularity by supporting unsustainable (and widely flouted) increases in regulated wages. This, in turn, impairs competitiveness and jeopardises recovery.
- > Weak governments with a large debt service obligation and subject to many demands from civil society, which have found it difficult to invest in long-term projects with the result that, when growth resumed, severe infrastructure shortages threaten to impede growth.
- > Post-crisis governments, which have had to deal with serious ethnic and religious tensions, notably Mindanao in the Philippines and Maluku, Aceh and Papua in Indonesia
- > National planning agencies (BAPPENAS in Indonesia and the NEDA in the Philippines), with responsibility for longer-term, economy-wide development priorities, which have been somewhat weakened and politicised.

There are also, of course, major differences. Historically, the Philippine decolonisation process was benign (although war-time damage was extensive), and its institutions survived intact. It had a major head start in public education and it retains its human capital advantage compared to Indonesia. The two countries' export patterns differ significantly, with the Philippines stronger in electronics and remittances and Indonesia stronger in natural resource content.

Indonesia has grown faster than the Philippines since the 1960s. Indonesia's current per capita income is more than five times that of its 1960 level, whereas for the Philippines it is just double. Economic growth under Soeharto had been significantly longer and stronger than under Marcos: 30 years of 4.5 per cent per capita growth compared to 18 years of around 3 per cent. Indonesia had the good fortune of two oil booms, and managed them both reasonably effectively, especially in recycling some proceeds into infrastructure and agriculture. Since 1966, Indonesia's macro-economic management has generally been more prudent, except for 1998. Moreover, Indonesia's crisis occurred quite suddenly, in the midst of strong growth, and with the initial trigger coming from abroad. In the Philippines, by contrast, growth was already slowing down in the early 1980s, and its crisis was primarily home-grown.

Indonesia has also recovered more quickly from deep crisis. By 2004, its per capita income had returned to 1996 levels, whereas the Philippines did not recover to 1983 levels until 2004.

Finally, Australia's bilateral relations with the two countries differ significantly. Its foreign policy, defence, commercial and education ties with Indonesia are much stronger, and there is a larger community in each country with knowledge of the other. Nevertheless, the bilateral political relationship has also been considerably more volatile, particularly on issues related to East Timor and Papua.

## Annex 2: The changing role of aid

### INDONESIA

#### The current aid environment

Indonesia is now much less dependent on aid. Net ODA flows to Indonesia in 2006 totalled US\$1.4 billion, equivalent to US\$6 per capita and 0.4 per cent of GNI (Table 3). Aid dependency is similar to the Philippines and substantially less than in Australia's other major aid partners. On the positive side, this means resource flows are unlikely to distort the economy and can presumably be ramped up or down quickly. To the extent that aid can promote better policies and public resource use, it can have a big multiplier effect throughout the economy. However, the main drivers of (and obstacles to) reform are likely to come from within Indonesia, as various domestic constituencies vie for power in a newly democratic and decentralised country.

- > Note that ODA numbers, as compiled by the DAC, include official grants and loans with a grant element of at least 25 per cent (at a discount rate of 10 per cent). Market-based lending from multilateral development banks is excluded.<sup>10</sup> In 2006, the International Bank for Reconstruction and Development (IBRD) and the ADB disbursed US\$1.9 billion in Indonesia; after repayments, net disbursements were negative (-US\$0.5 billion).

The composition of aid flows is changing:

- > While the IFIs see a continuing role in middle-income countries, the reality is their financial flows to Indonesia are likely to decline. Concessional flows from the IDA and ADF will end this year, and Indonesia has increasing access to international financial markets for loan funds.<sup>11</sup> It is government policy to reduce external debt by maintaining negative net flows from official lenders. And the Government is keen to demonstrate it no longer depends on IFIs for money and advice.
- > Most bilateral aid, except from Japan, is in the form of grants. Here the outlook is mixed. Some donors, such as the DFID, are reducing their aid to Indonesia and reallocating the funds to poorer, fragile states, especially in Africa. Others, such as the Netherlands, see opportunities for additional aid to support specific initiatives such as climate change. But Australia is the only one to embark on a significant expansion of the country program. On a net basis, Australia is now the second-largest provider of ODA in Indonesia, after Japan.
- > Not a lot is known about other non-traditional aid providers, such as China and a number of Middle Eastern countries, which are almost certainly becoming significant sources of funds. Much of this money is directed at infrastructure projects and associated with parastatal and private investments. The main danger here is the lack of transparency about the financial terms and the risk that environmental and social issues will be overlooked.<sup>12</sup>

The changing levels and composition of aid is associated with changes in the mechanisms for aid coordination. The CGI was abolished last year. While it had evolved in recent years toward a co-chaired, policy forum with wider participation, it lost its relevance in the new Indonesia and had become a political

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<sup>10</sup> Japan's International Finance Sector loans (previously JEXIM) are also excluded.

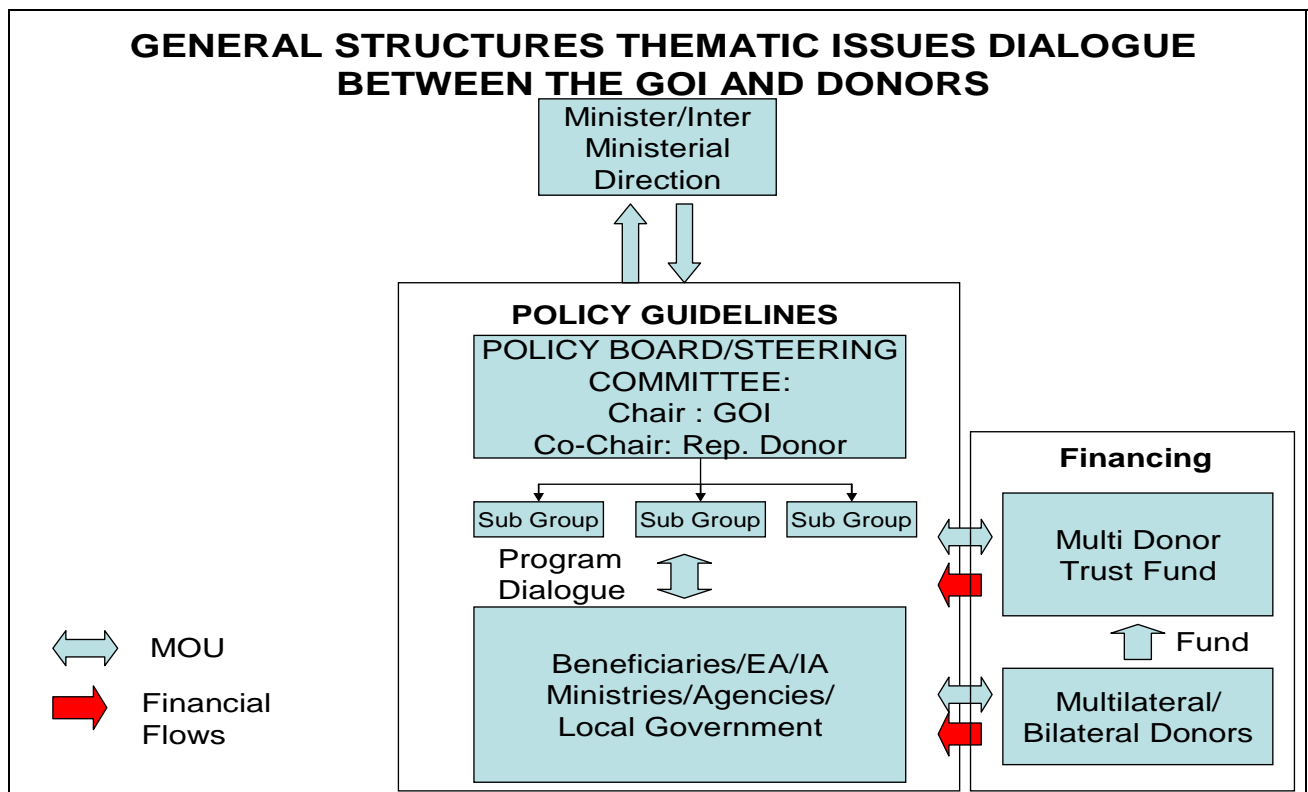
<sup>11</sup> This assumption has been weakened by the current volatility in global financial markets, and Indonesia has approached the World Bank, the ADB, Japan and Australia for additional program loans to finance the budget deficit this year.

<sup>12</sup> Indonesia may also benefit from other, more benign sources of assistance, such as grants from private foundations (for example, the Bill & Melinda Gates Foundation in the health sector). More work is needed to understand the size and contribution of these new sources of funding and their implications for the Australian aid program.

liability for the Government. In its place, BAPPENAS is proposing a new donor coordination mechanism (Table 2).

This new mechanism is already starting to work in some areas—such as education, poverty and decentralisation—where donor working groups and multi-donor trust funds were already in place.<sup>13</sup> But this will be a challenge in other areas, such as climate change, where Government of Indonesia leadership is weak and BAPPENAS struggles to coordinate a large number of actors. More generally, there is a need to strengthen the capacity of BAPPENAS to coordinate aid, especially now that leadership is expected to come from the Government's side.

**Table 2: Proposed donor coordination mechanism**



Source: BAPPENAS

### The role of Australian Aid

What is the rationale of expanding aid in a middle-income country? Australia has committed to increase its aid program to 0.5 per cent of GDP by 2015. This means it could rise to A\$8 billion from current levels of A\$3 billion (and only A\$1.5 billion a few years ago). Indonesia, because of its proximity and the importance of the bilateral relationship, has always been a priority recipient of Australian aid. The country program was substantially expanded after the tsunami, with the addition of the AIPRD. The current program, including the AIPRD, is A\$459 million—making it the largest Australian aid program.<sup>14</sup>

Australia is now finalising a new Australia Indonesia Partnership Country Strategy for 2008–2011. While there are no specific numbers, the presumption is that the current program will be sustained and possibly

<sup>13</sup> The authors heard mixed reviews on the working of multi-donor trust funds. One of the most contentious is the Decentralization Support Facility (DSF), set up with DFID funding and managed by the World Bank. In practice, it tended to divide donors and lacked strong Government of Indonesia leadership. This is now being turned around, in part due to Australian involvement.

<sup>14</sup> Followed by Papua New Guinea (A\$356 million), Solomon Islands (A\$224 million), the Philippines (A\$101 million) and Vietnam (A\$91 million).

expanded over the next five years. In the view of the ODE team, this case can be based on these arguments (drawing on Annex 1 in the Indonesian development and institutional context):

- > **Poverty:** Indonesia is a ‘marginal’ middle-income country. Parts of the country, including Eastern Indonesia, have made slow progress on reducing poverty and improving MDGs. Even Java has large numbers of poor people, and many are vulnerable to falling back below the poverty line (for example, due to the current rise in rice prices). Support for poverty programs and basic services remains a high priority.
- > **Capacity:** Compared to other middle-income countries, Indonesia suffers from many years of institutional neglect and poor-quality education. Long-term assistance to address these constraints to capacity is essential if Indonesia is to address its own problems: improving the policy environment for development and building the capacity of government, at central and local levels, and within civil society.
- > **Stability:** Australia’s objective is to have a strong national interest in a stable Indonesia. Tackling poverty is one main way to meet this objective. However, stability also requires engagement on a range of other issues, including anti-terrorism, money-laundering, judicial reform, political development and natural disaster management. Some of these engagements can be supported through the whole-of-government aid program.
- > **Climate change:** Indonesia’s CO2 emissions are the third-highest in the world, behind only China and the United States. The overwhelming proportion of these emissions originates in the country’s corrupt and largely illegal deforestation program. Building on the Bali environment summit in December 2007, there is now global interest in helping Indonesia tackle these long-standing issues, and Australia is becoming engaged through the Global Initiative on Forests and Climate Change.

In scaling up the aid program, Australia can draw on a number of assets:

- > **Grant aid:** The AIPRD introduced some loans into the Indonesian program, although experience confirms this was not a positive step. So, post-AIPRD the program should revert to a 100 per cent grant program. This provides obvious financial advantages to Indonesia, over commercial or non-concessional borrowing, and also simplifies administration, especially when funds are to be channelled through local governments.<sup>15</sup>
- > **Untied aid:** Australian aid is now untied. This means Indonesia can access the very best goods and services from around the world, which improves both the efficiency and effectiveness of aid. Australian aid can also be channelled directly to NGOs, without the costs and risks of working through government systems.
- > **Long-term commitment:** While other aid programs tend to come and go, depending on the provider’s global priorities, Australia’s national interest in a stable and prosperous Indonesia ensures long-term commitment. This allows the aid program to tackle longer-term institutional and capacity constraints and monitor progress over an appropriate time-frame.

Building on this, the approach to aid in Indonesia will have to change to reflect the current realities of the country and the challenges of a larger aid program. The ODE team proposes some of these general principles:

- > Make an explicit commitment to long-term building of institutions and human capacity. This was a recurring theme of the authors’ discussions in Jakarta. People from all sectors stressed the relative weakness of Indonesian institutions and human capacity and the scope for Australia to provide long-term assistance in this area. This would call for a more strategic approach to scholarship programs, more focus on core funding for research institutes and civil society organisations, and coordinated support to reforming ministries and local governments. New types

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<sup>15</sup> Lack of clarity in the on-lending arrangements to local governments continues to delay implementation of many World Bank and ADB programs.

of monitoring systems would be needed to track progress in these long-term, inherently complex areas.

- > Provide enough flexibility to scale up assistance when opportunities arise. It is always risky to tie success to a few key personalities. But the reality is that progress in Indonesia (or anywhere for that matter) is difficult without strong leadership from the top. At the moment, for example, many reforms in public financial management and civil service reform are being driven by the Ministry of Finance. Australia has TA in place, which has contributed to some important reforms (for example, in tax administration). But a more responsive and coordinated approach could make a difference and hopefully leave in place some institutional changes that would survive future changes in personnel.
- > Use a wider range of instruments to deliver assistance. Until recently, the Australian aid program was based largely on traditional TA and project models.<sup>16</sup> Under the AIPRD, Australia has moved into larger sector programs (for education and roads) and is increasingly looking at working with other donors on sector-wide (education) and regional (Aceh) approaches. This inevitably involves working through government systems: strengthening Government of Indonesia resource management while ensuring adequate safeguards are in place to protect Australian funds.<sup>17</sup> Opportunities for even purer forms of budget support, tied to key policy reforms, will also arise as the program grows. A clear strategy for selecting and balancing these instruments is urgently needed.
- > Develop the capacity of AusAID staff to engage on substantive issues with Indonesian counterparts. Aid management and administration inevitably absorb a great deal of staff time. But the sort of program emerging is conditional upon staff having deep knowledge of Indonesian development issues and capacities. At the moment, a lot of this knowledge comes from working through multilateral agencies, such as the World Bank and the ADB. But as the influence and capacity of these agencies wanes, Australia will have to do more of the 'heavy lifting'. Some of this capacity will be in-house, but most will come from engaging local institutions and experts. Knowing whom to talk to, and having access, will be key.
- > Improve the overall governance of the program, with more scope for Indonesian leadership. Under the AIPRD, a new governance structure was introduced, with a Joint Commission at the top (overseen by the Australian Prime Minister and the Indonesian President) and supported by a Secretaries Committee in Australia. By all accounts this structure has worked relatively well, but will soon need to be replaced with a more permanent arrangement for the whole program, with greater Indonesian involvement in formulating priorities and positions.

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<sup>16</sup> These forms of assistance are still relevant. As a grant provider, Australia can usefully supplement sector-wide programs by providing TA or project assistance to implementing agencies. This can encourage their participation, when the incentive effects of budget support are weak.

<sup>17</sup> The program is preparing a roadmap to guide increased use of Indonesian Government systems, building on the commitment in the draft country strategy and the framework provided by the draft anti-corruption plan.

## THE PHILIPPINES

### The current aid environment

Aid dependency in the Philippines is low. Net ODA flows to the country in 2006 totalled US\$562 million, equivalent to US\$6 per capita and 0.4 per cent of GNI (Table 3). Aid dependency is similar to Indonesia and substantially less than in Australia's other major aid partners. On the positive side, this means resource flows are unlikely to distort the economy and can presumably be ramped up (or down) quickly. To the extent that aid can promote better policies and use of public resources, it can have a big multiplier effect throughout the economy. However, donors have to be realistic about what aid can achieve in an uncertain political environment where progress on reforms is likely to be slow at best.

- > Note that ODA numbers, as compiled by the DAC, include official grants and loans with a grant element of at least 25 per cent (at a discount rate of 10 per cent). Market-based lending from multilateral development banks is excluded.<sup>18</sup> In 2007, the IBRD and the ADB disbursed US\$800 million in the Philippines; after repayments, net disbursements were only US\$160 million. As a middle-income country, the Philippines no longer qualify for concessional lending from the IDA and the ADF.

The sources of aid seem to be in flux, responding to changing priorities in aid agencies and the performance of the Philippine Government:

- > The World Bank and ADB country strategies both envisage relatively large programs in the Philippines, with annual lending planned to be US\$400 million to US\$1,100 million and US\$350 million to US\$500 million respectively, depending on performance. However, in practice, their programs have diverged, at least in the short term. While the ADB is likely to lend around US\$750 million this year, largely through program loans, the World Bank has been affected by slow progress on policy reforms and corruption concerns (roads).<sup>19</sup> Actual lending in financial year 2008 was expected to be US\$245 million.
- > Historically, the two largest bilateral aid providers to the Philippines have been Japan and the United States. Japan continues to have a sizeable grant program through Japan International Cooperation Agency (JICA).<sup>20</sup> However, there has been something of a hiatus in the Japan Bank for International Cooperation (JBIC) – ODA lending to the Philippines in recent years, due to a range of fiscal concerns (counterpart funds, VAT exemption, etc). As these issues are resolved, lending could pick up again, including possible policy loans with the World Bank and the ADB. Similarly, the USAID program in the Philippines has been cut back over the past decade, and now runs around US\$80 million per annum. However, grant assistance from the Millennium Challenge Corporation (MCC) could be substantial, if the Philippines graduates from threshold to eligible status (with progress on tax administration and anti-corruption efforts).
- > China is emerging as a major new source of concessional funding in the Philippines, recently promising US\$1.8 billion to support infrastructure projects. However, little is known about the terms or use of these funds. Earlier this year, Philippine President Arroyo halted 11 pending Chinese-funded projects, following allegations of corruption in the award of a contract to ZTE Corporation to supply broadband equipment to the Government. This is indicative of concerns about the transparency of Chinese assistance; there is also a risk that broader governance, environmental and social issues will be overlooked.

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<sup>18</sup> Japan's International Finance Sector loans (previously JEXIM) are also excluded. These average around US\$1 billion per annum, but are more commercial in nature and net flows after repayments are probably small or negative.

<sup>19</sup> Funding for the second phase of the National Road Improvement and Management Program (NRIMP) was withdrawn from the World Bank Board in October 2007, pending completion of the corruption investigations into procurement under the first phase. This project was finally approved in May 2008.

<sup>20</sup> Japanese aid will be reorganised in October 2008, with all JICA grants and JBIC – ODA loans consolidated into a 'new' JICA. The export credit side of JBIC will be incorporated into the new Japan Finance Corporation (JFC).

Aid coordination is more effective in the Philippines than in Indonesia, largely due to the role played by the PDF, established in 2005 to replace the CGI. While the CGI evolved in a similar direction (co-chaired, policy discussion, with wide participation), the PDF seems much more accepted as a Philippines-owned process.<sup>21</sup> It is also backed by a series of active working groups, which keep the policy dialogue going between meetings.

The most recent meeting of the PDF was held on 26 to 27 March 2008. The theme was ‘Accelerating Inclusive Growth and Deepening Fiscal Stability’ and more than 300 participants from the Government, international development community, business groups and civil society attended. Many participants commented on the high level of government representation (including President Arroyo and half of her Cabinet) and the frank nature of the discussion (including private-sector concerns about corruption). While some government representatives took exception to the focus on corruption, most accepted it was a legitimate part of the development debate. The only negative comment the authors picked up was on the breadth of the agenda—and the difficulty of doing justice to the detailed preparatory work by the working groups.

While most aid providers have a formal relationship with the Ministry of Finance (for loans) or the Ministry of Foreign Affairs (for grants), day-to-day coordination is usually provided by the NEDA. There are concerns that the role of the NEDA has become more political with recent changes at the top. However, at the technical level, the capacity is still largely in place. Therefore, with strong leadership, the NEDA could quickly recover its economic development and aid coordination roles. There is even talk of establishing an independent planning agency—as provided for in the 1987 Constitution. However, it is likely that the political environment will remain uncertain through the 2010 elections, inevitably constraining NEDA’s effectiveness. If this situation persists much longer, some of the better staff will likely start to look for careers elsewhere.

### The role of Australian aid

Australia is becoming a prominent donor in the Philippines. The Australian aid program rose from A\$70 million in 2006–07 to A\$101 million in 2007–08.<sup>22</sup> This makes Australia the second-largest provider of net ODA after Japan.<sup>23</sup> The current Australia – Philippines Development Assistance Strategy for 2007–11 foreshadows further expansion, with strong emphasis on improving economic growth and basic education services, and a continuing regional focus on Mindanao (accounting for about half of the current aid program).

The case can be made for an expanded aid program in the Philippines:

- > **Poverty:** While the Philippines is a middle-income country, about one-third of the population, or 28 million people, fell below the national poverty line in 2006. Despite reasonable growth, there has been little progress on reducing the incidence of poverty since 2000, and inequality remains high by Asian standards. Nationwide, progress on the access to education and maternal health MDGs is slow, and MDG indicators in the poorer regions—such as the ARMM, southern Luzon and the eastern Visayas—are similar to many low-income countries.
- > **Capacity:** The Philippines has a much stronger human capital base than does Indonesia. However, this is starting to erode, as dropout rates rise for basic education and higher-level education institutions are run down. Traditionally, the Philippines has looked to the United States to fund its public universities and think tanks, and to provide scholarships for post-graduate study, but this funding is now drying up. Further, public universities and think tanks are increasingly disadvantaged by public-sector pay and recruitment policies.

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<sup>21</sup> It is possible that the PDF could go the way of the CGI, if the country’s mood becomes more nationalistic after the 2010 elections. But the general sense of people the authors talked to in Manila is that it will stay and remain effective for the foreseeable future.

<sup>22</sup> The Philippines is now the fourth-largest recipient of Australian aid after Indonesia (A\$459 million), Papua New Guinea (A\$356 million) and Solomon Islands (A\$224 million).

<sup>23</sup> ODA excludes market-based assistance from the ADB and World Bank. In 2007, net disbursements from the ADB and IBRD were US\$211 million and US\$53 million respectively.

- > **Stability:** Long-standing conflicts, especially in Mindanao, undermine development in the southern Philippines and raise broader security concerns in the region. Unfortunately, the prospects for peace remain uncertain, and this inevitably constrains what can be achieved on the development front. But, equally, donors have to be ready to respond quickly—if and when a peace deal is signed.  
  
The pace of expansion, however, is likely to be constrained by two factors:
- > **Political situation:** Despite recent progress on the economic front, the mood in Manila is very negative toward the Arroyo administration. Concerns about corruption, political interference in decision making, and the lead-up to the 2010 election are all reflected in the President's approval ratings, which are at record lows. In some respects, these concerns are also present in Indonesia. However, there is less questioning of the President's motives in Indonesia, and the expectation is that reforms will continue, albeit at a slow pace.
- > **Bilateral relationship:** Australia does not have the same breadth or depth of bilateral relations with the Philippines as it has with Indonesia. Although the Philippine community in Australia is growing, Australian mining firms have interests in the Philippines, and the Australian Government has paid more attention to security concerns in the south since September 11, the bilateral ties are much weaker than in Indonesia. Similarly, there is a much longer tradition of Indonesian studies and scholarships in Australian universities. There is no reason why these bilateral ties should not expand, especially as the presence of the United States declines. However, it will inevitably take time to build the level of country knowledge, understanding and presence that Australia has in Indonesia.

In this environment, scaling up of the aid program in the Philippines will have to go hand-in-hand with a change in approach. While implementing these changes will be easier in an expanding program, they could also have implications for ongoing programs and priorities:

- > Make an explicit commitment to long-term building of institutions and human capacity. Australia already has a successful program of support to basic education in Mindanao and the Visayas, which is being scaled up to the national level. There is also scope to expand the scholarship programs. This could be supplemented by a long-term program of support to public universities (like the University of the Philippines) and think tanks (like the PIDS). The aim would be to maintain the quality of graduates entering the civil service and the role of these institutions in policy analysis. In the process, Australia would also strengthen its bilateral relationship and build up the deep knowledge needed to inform a larger aid program.
- > Provide enough flexibility to scale up assistance when reform opportunities arise. Australia is considering cofinancing the next development policy loan from the World Bank. While this could be one way to disburse additional funds quickly, the pros and cons of this approach in the current political environment need to be carefully assessed. Much will depend on the seriousness of the underlying policy dialogue (which may in turn delay disbursement). Similarly, Australia needs to be ready to respond quickly if and when a peace deal is signed in Mindanao.<sup>24</sup> Many lessons learned from Aceh (including the pros and cons of working through multi-donor trust funds) may be relevant here. Beyond Mindanao, Australia is looking at ways to support progressive local governments. At this level, additional aid can have a strong incentive effect. However, it must be balanced against the risks that reforming leaders come and go. Therefore, as at the centre, quick-disbursing budget support should be packaged with a core program of longer-term assistance for institution building.

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<sup>24</sup> The program's focus on Mindanao is likely to be diluted as Australia supports national programs and progressive local governments in other poor regions. There are also concerns about donor coordination and absorptive capacity in Mindanao. Even so, the scope for an even larger program, with a peace deal, needs to be explored.

- > One risk of a larger program is that Australia may lose its flexibility to respond to small-scale requests for assistance (up to, say, A\$1 million). The authors were presented with several interesting proposals: for example, the Asia Foundation's work on regulatory reform, the Social Weather Station's corruption surveys, and Peter Wallace's computer training for the blind. These types of initiatives can have an immediate development impact and also strengthen Australia's presence in the country. However, it can be a challenge to design selection and monitoring systems that ensure good governance, without overwhelming small-scale schemes. This is likely to be an issue for Australia in many countries—and probably needs an agency-wide response.
- > Support ongoing efforts to strengthen national systems, and use them as appropriate, while managing the risks of corruption. The new procurement law, passed in January 2003, is considered a major step forward in the national procurement system (and well ahead of progress in Indonesia). A number of development partners, including the World Bank, ADB and JBIC, are aligning their procurement rules with the national system. Now that Australian aid is untied, it should also consider working with the national system wherever possible. However, as the World Bank's experience in the roads sector shows, there are no guarantees against corruption. Indeed, more effective national systems of oversight and auditing are likely to bring more cases of corruption to light. Australia needs to be ready to respond quickly with effective public information and remedial action. Experience with the project-specific, anti-corruption action plans under the AIPRD in Indonesia may well be relevant to the Philippines program in the future. Opportunities to strengthen the anti-corruption component of priority programs—such as is now being discussed for the Conditional Cash Transfer—are also well worth pursuing.<sup>25</sup>
- > Develop the capacity of AusAID staff to engage on substantive issues with Philippine counterparts. Aid management and administration inevitably absorbs a lot of staff time. But the sort of program now emerging is conditional upon staff having deep knowledge of the Philippines' development issues and capacities. At the moment, much of this knowledge comes from working through such multilateral agencies as the World Bank and the ADB.<sup>26</sup> However, these bodies are also looking for substantive partnerships and do not like being treated as managing contractors. When Australia asks for a seat at the table, it must be filled with someone who can hold his or her own in policy discussions. Recent experience with the appointment of a country economist in Manila has been positive in this regard. Australia also seems to be well equipped in the education sector, but it will take time to build this capacity in new sectors such as roads, health and agriculture.<sup>27</sup> This is why engagement with local institutions and experts is so important. Knowing whom to talk to, and having access, will be key.
- > Improve the overall governance of the program, with more scope for Filipino leadership. It seems that NEDA is already doing a good job of day-to-day coordination, within the overall framework set by the PDF. In that sense, the Philippines is ahead of Indonesia. The country program is also establishing a high-level advisory group of Filipino and Australian experts to help guide the program's direction. This seems adequate for now, but if there are plans for a substantially larger program—possibly in the range of A\$200 million to A\$300 million per annum—then a more formal joint governance structure may be justified. Here it may be worthwhile to learn from the experience under the AIPRD and the plans to extend and modify this approach for the whole of the Australian – Indonesian partnership.

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<sup>25</sup> The Conditional Cash Transfers will provide financial support to poor families who meet certain education and health commitments. This is potentially a good way to meet Australia's poverty and MDG objectives, provided the scheme works well—hence the value of working on the anti-corruption component.

<sup>26</sup> Both the World Bank and the ADB are interested in tapping AusAID grant funds to cofinance their investment operations, especially for TA components. AusAID is also discussing a possible umbrella trust fund with the World Bank, which would allow multiple grants to be channelled through various financing windows.

<sup>27</sup> Australia has supported rural development through projects on the Land Administration and Management Project and agriculture research (the ACIAR). However, substantial analytical work would be required to address the current rice crisis or longer-term issues of rural poverty.

While most of these proposals fall within the scope of the country program, some could be facilitated by an agency-wide review of:

- > **business lines:** the case for support to public universities and think tanks, as well as for small-scale grants, in the context of Australia's overall aid objectives
- > **budget allocations:** the balance between special initiatives and country budgets and the flexibility to change country budgets based on performance
- > **administrative budgets:** it will be difficult to implement larger aid programs effectively without some growth in administrative budgets, especially for expert staff in the field
- > **staffing policies:** there should be a premium on country knowledge, including language training, longer postings in the field and return assignments.

## Annex 3: Definitions of Official Development Assistance, official aid, grants and other revenue

### **Official development assistance and official aid (current US\$)**

Net official development assistance consists of disbursements of loans made on concessional terms (net of repayments of principal) and grants by official agencies of the members of the DAC, by multilateral institutions, and by non-DAC countries to promote economic development and welfare in countries and territories in Part I of the DAC list of recipients. It includes loans with a grant element of at least 25 per cent (calculated at a rate of discount of 10 per cent). Net official aid refers to aid flows (net of repayments) from official donors to countries and territories in part II of the DAC list of recipients: more advanced countries of Central and Eastern Europe, the countries of the former Soviet Union, and certain advanced developing countries and territories. Official aid is provided under terms and conditions similar to those for ODA. Data are in current United States dollars.

#### **Source:**

OECD Development Assistance Committee, Geographical Distribution of Financial Flows to Aid Recipients and Development Cooperation Report.

### **Grants and other revenue (current LCU)**

Grants and other revenue include: grants from other foreign governments, international organisations, and other government units; interest; dividends; rent; required, nonrepayable receipts for public purposes (such as fines, administrative fees, and entrepreneurial income from government ownership of property); and voluntary, unrequited, nonrepayable receipts other than grants.

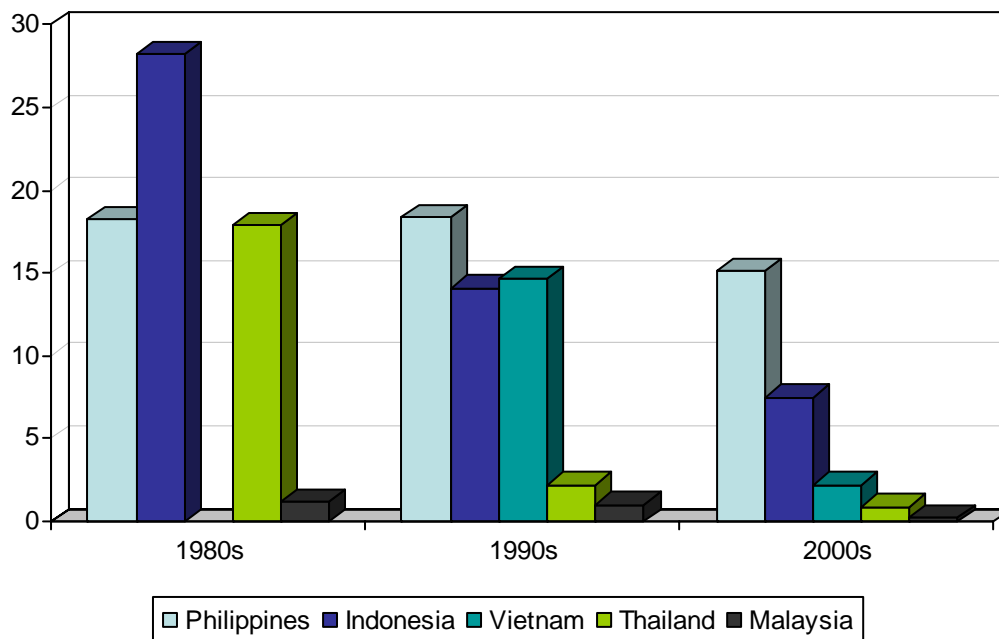
#### **Source:**

International Monetary Fund, Government Finance Statistics Yearbook and data files.

## Annex 4: Social indicators

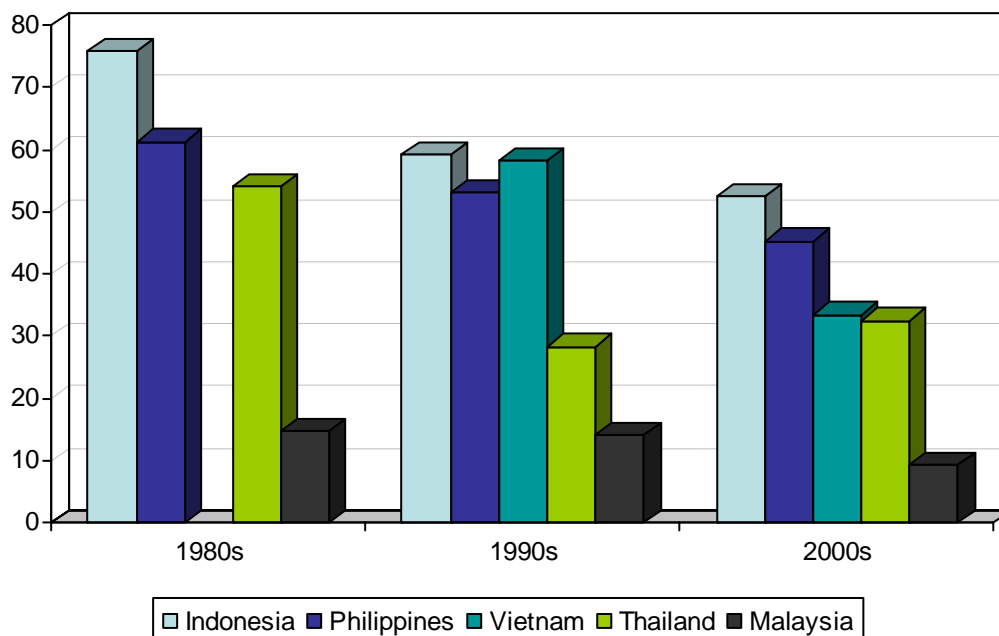
In this and the following annex the authors present longer term data on a range of socioeconomic indicators for Indonesia and the Philippines and compare them to the Southeast Asian context. The purpose is to illustrate some of the major development dynamics and challenges discussed in the report. The focus is on decades rather than years, and thus annual data for the very recent period are not presented. All figures, unless otherwise indicated, are in US\$.

**Population below \$1 a day, %**



Source: World Bank PovcalNet.

**Population below \$2 a day, %**



Source: World Bank PovcalNet.

### Income inequality

	1980s	1990s	2000s
Indonesia	33.1	36.5	34.3
Malaysia	47.0	48.5	49.2
Philippines	40.6	42.9	46.1
Thailand	43.8	43.4	42.0
Vietnam	–	35.7	34.4

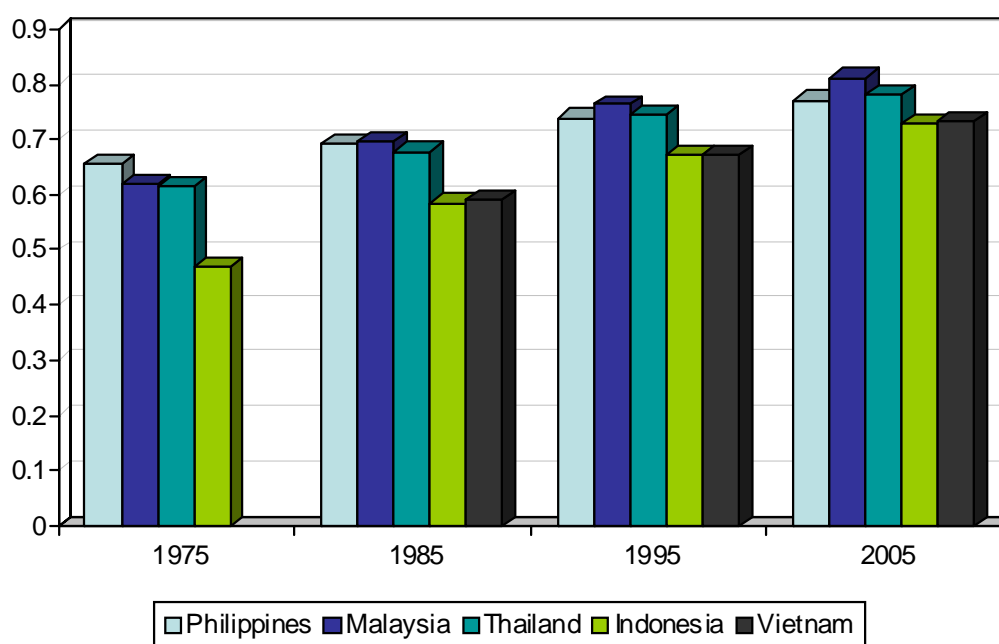
Note: The Gini indices shown here may deviate considerably from corresponding country estimates. This is due to the method used to calculate the comparative series.

Estimates for Malaysia in 2000 are that of the late 1990s.

- No estimates available.

Source: World Bank PovcalNet

### Human Development Index



**Life expectancy at birth**

	1975	1985	1995	2005
Indonesia	52.7	60.2	65.1	67.8
Malaysia	65.3	69.5	71.9	73.7
Philippines	60.1	64.3	68.6	71.0
Thailand	61.2	66.3	68.3	70.9
Vietnam	58.3	63.4	68.1	70.7

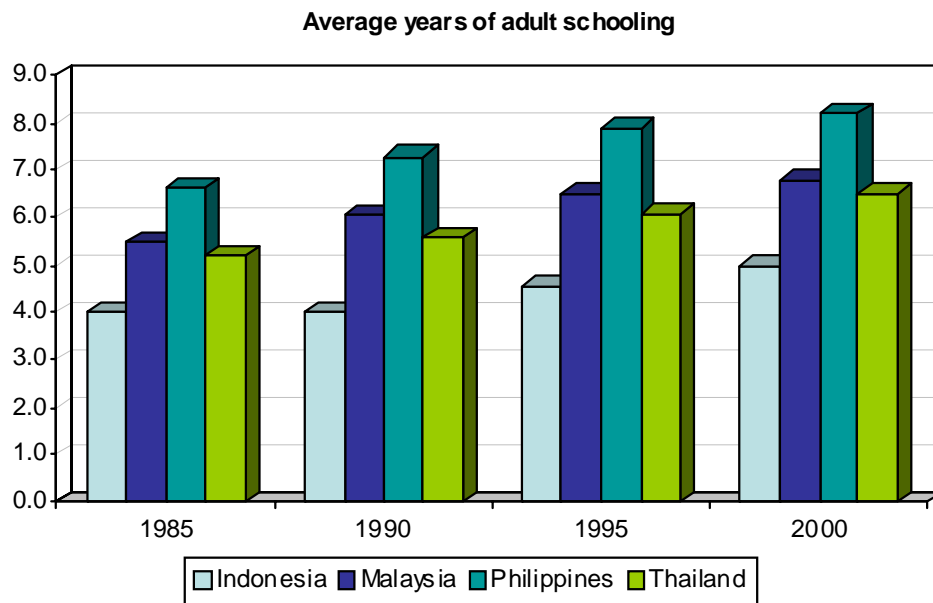
Source: World Development Indicators.

**Education indicators by %**

	1975	1985	1995	2005
<i>Adult literacy rate<sup>a</sup></i>				
Indonesia	62.8	74.6	83.5	90.4
Malaysia	64.9	76.3	84.3	88.7
Philippines	85.0	90.0	93.5	92.6
Thailand	84.4	90.2	94.1	92.7
Vietnam	85.5	89.2	91.5	90.3
<i>Primary enrolment rate</i>				
Indonesia	86.0	117.0	113.4	114.8
Malaysia	94.5	100.7	103.4	100.5
Philippines	108.6	107.4	114.1	111.2
Thailand	83.6	96.1	86.5	109.4
Vietnam	107.0	103.0	114.1	105.8
<i>Secondary enrolment rate</i>				
Indonesia	20.0	41.3	51.5	62.2
Malaysia	45.7	53.0	58.7	69.1
Philippines	53.9	64.4	77.5	84.8
Thailand	25.1	30.5	54.1	77.2
Vietnam	39.4	42.7	47.0	64.6

<sup>a</sup>Adults aged 15 and above

Source: UNDP Human Development Reports, World Development Indicators.



Note: Adults ages 15 and above.

Source: World Bank EdStat.



## Annex 5: Economic

## indicators

## Key indicators, 2005

	GDP, \$ millions	Average annual GDP growth rate (1960–2005)	Per capita GDP \$	Per capita GDP \$PPP	ODA, \$ millions	ODA (% of GDP)	Population living below \$1 a day <sup>a</sup> %	Population living below \$2 a day <sup>a</sup> %
Indonesia	287 217	5.4	1 302	3 843	2 523	0.9	7.5	52.4
Malaysia	130 326	6.4	5 142	10 882	32	0.0	<2	9.3
Philippines	99 029	3.9	1 192	5 137	561	0.6	14.8	43.0
Thailand	176 634	6.4	2 750	8 677	-171	-0.1	<2	25.2
Vietnam	52 408	6.5	631	3 071	1 905	3.6	<2	33.4

<sup>a</sup> reference year differs: Philippines—2003, Indonesia and Thailand—2002, Vietnam—2000, and Malaysia—1997

Source: *World Development Indicators and World Bank Poverty Net*

**Average annual GDP per capita growth (%)**

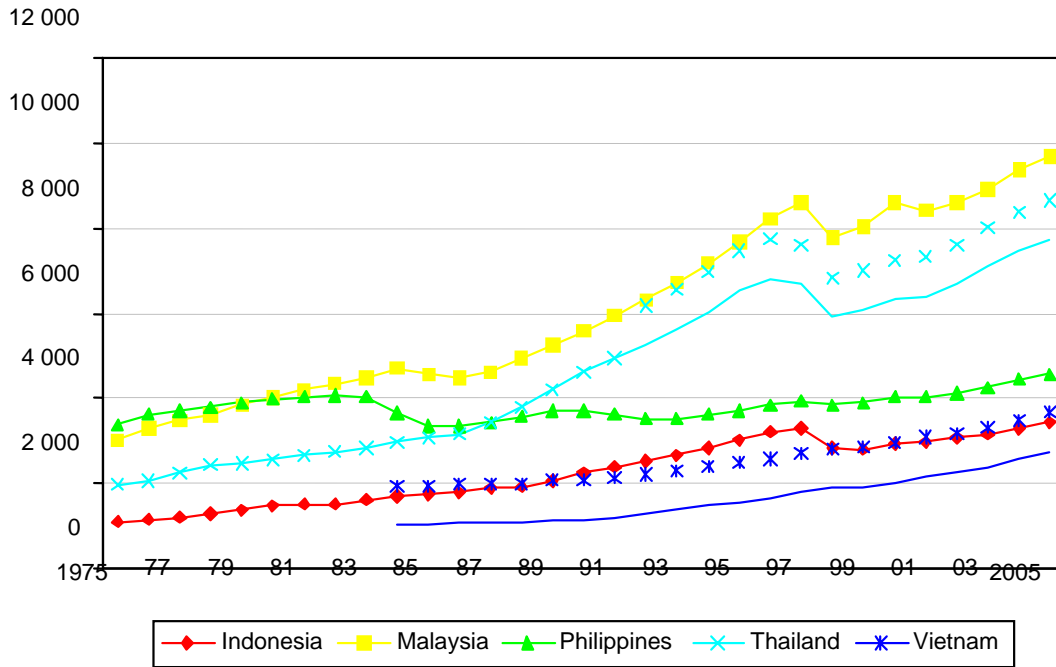
	1960s	1970s	1980s	1990s	2000s
Indonesia	1.4	5.3	5.5	3.3	3.4
Malaysia	3.5	5.2	3.2	4.5	3.2
Philippines	1.9	2.9	-0.4	0.6	2.7
Thailand	4.6	4.6	5.6	4.0	4.0
Vietnam	–	–	2.1	5.5	6.1
East Asia and Pacific	1.6	5.0	6.0	6.8	7.2
Low income	1.7	0.7	1.9	2.2	3.9
Middle income	4.7	3.1	0.9	2.0	4.1
High income	4.3	2.8	2.2	1.8	1.7

Authors' estimates.

Income groupings are according to 2004 GNI per capita calculated using the World Bank Atlas method. Low income = \$825 or less; middle income = \$826 to \$10 065; high income = \$10 066 or more.

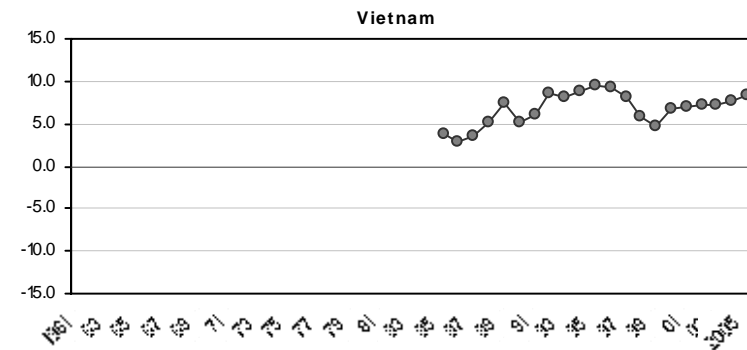
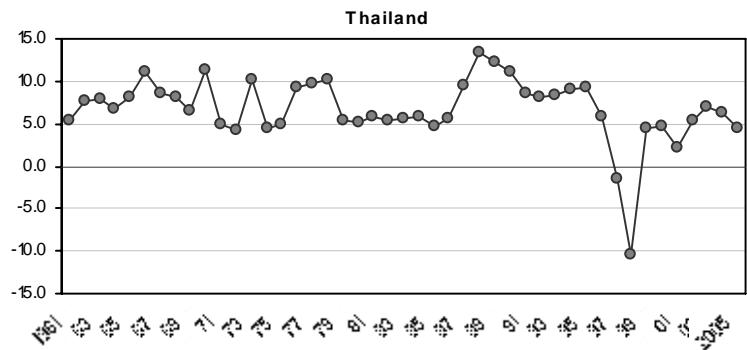
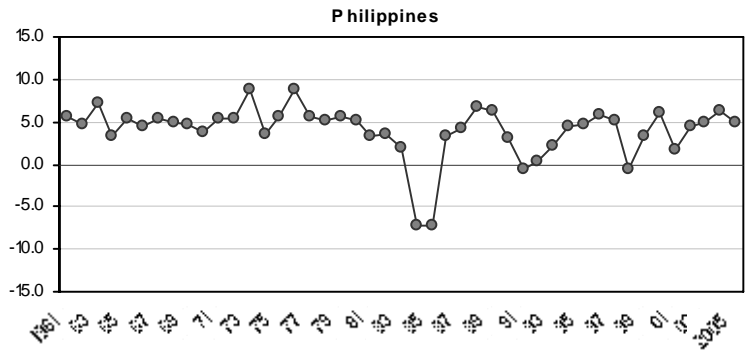
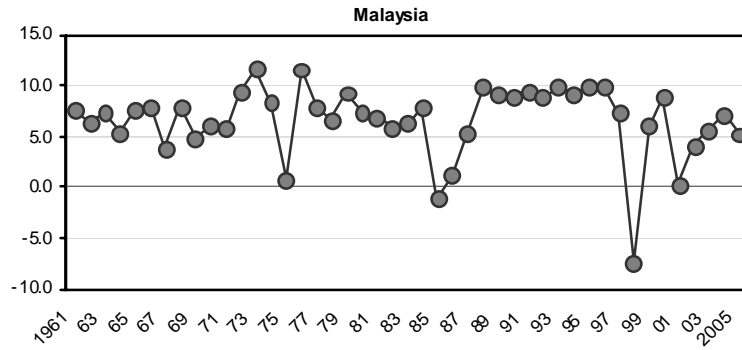
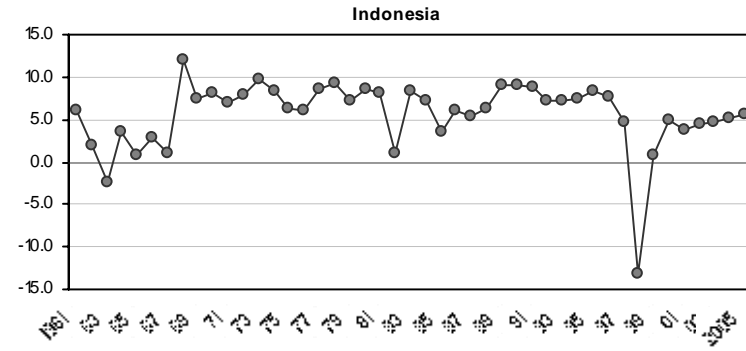
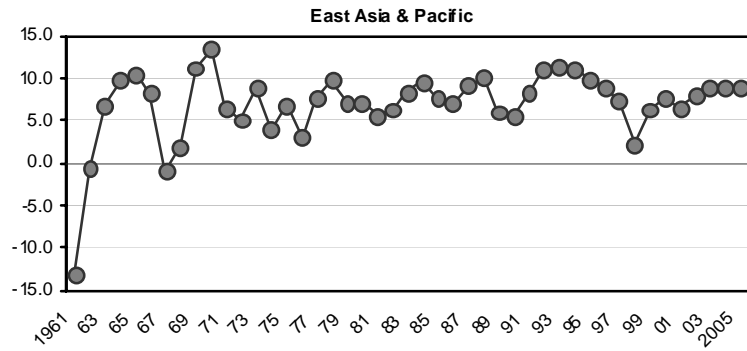
Source: *World Development Indicators*.

### GDP per capita PPP (in constant 2000 US\$)

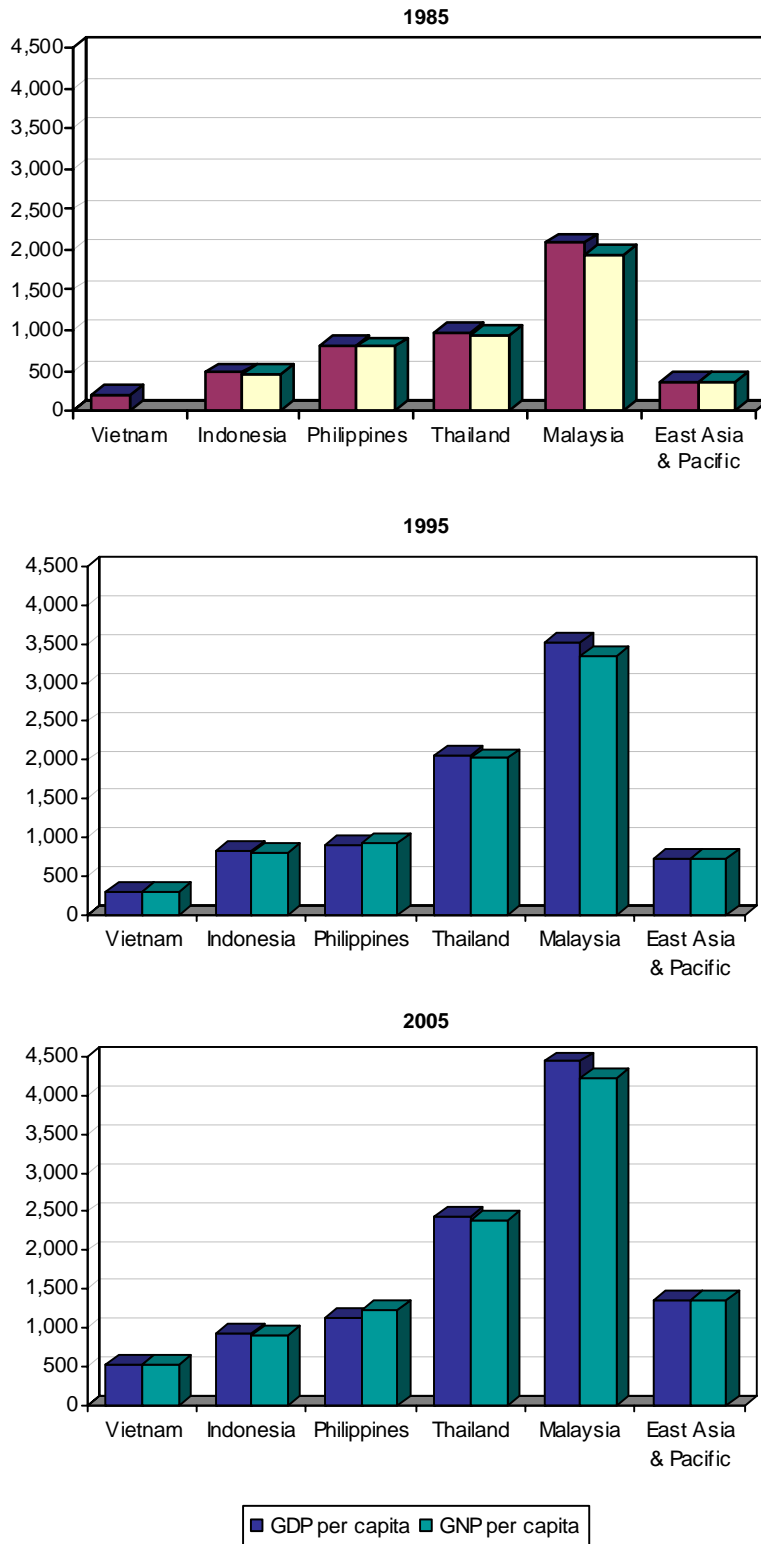


Making a difference in middle-income countries?

Annual GDP growth rate, (%)



**GDP and GNP per capita, in 2000 US\$**



Source: World Development Indicators.

**ODA Ratio to GDP, Government Expenditure and Gross Capital Formation %**

	1960s	1970s	1980s	1990s	2000s
<i>GDP</i>					
Indonesia	4.0	2.8	1.2	1.1	0.7
Malaysia	0.7	0.7	0.6	0.2	0.1
Philippines	0.8	1.2	1.6	1.8	0.7
Thailand	1.0	0.8	1.1	0.6	0.0
Vietnam	–	–	1.0	3.9	4.3
<i>Government expenditures</i>					
Indonesia	59.1	33.0	11.8	14.1	9.7
Malaysia	5.0	4.3	4.1	1.6	0.7
Philippines	9.4	12.4	19.3	16.7	6.2
Thailand	10.4	7.6	8.8	6.0	0.4
Vietnam	–	–	25.2	51.5	67.5
<i>Gross capital formation</i>					
Indonesia	37.1	14.3	4.1	4.7	3.1
Malaysia	3.8	3.0	2.4	0.7	0.4
Philippines	4.1	4.9	8.4	7.9	4.0
Thailand	5.2	3.2	3.7	1.9	0.3
Vietnam	–	–	6.2	17.4	12.9

Authors' estimates.

Source: World Development Indicators.

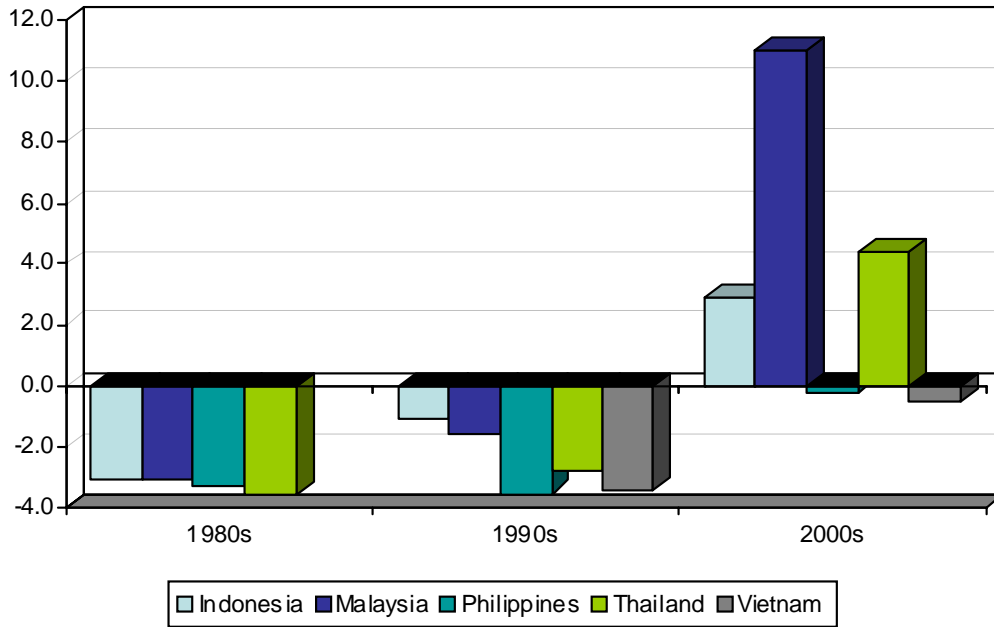
**Debt service ratio to GNP and exports %**

	1970s	1980s	1990s	2000s
<i>Gross National Product</i>				
Indonesia	3.5	6.8	10.9	8.7
Malaysia	3.2	10.6	7.9	8.3
Philippines	4.5	8.9	7.3	10.9
Thailand	2.8	6.5	7.2	12.5
Vietnam	–	3.7	2.8	2.9
<i>Exports of goods and services</i>				
Indonesia	15.5	26.7	33.7	24.2
Malaysia	6.8	17.1	8.5	6.6
Philippines	20.9	35.7	21.0	23.3
Thailand	14.9	25.5	15.8	18.3
Vietnam	–	4.0	7.2	4.9

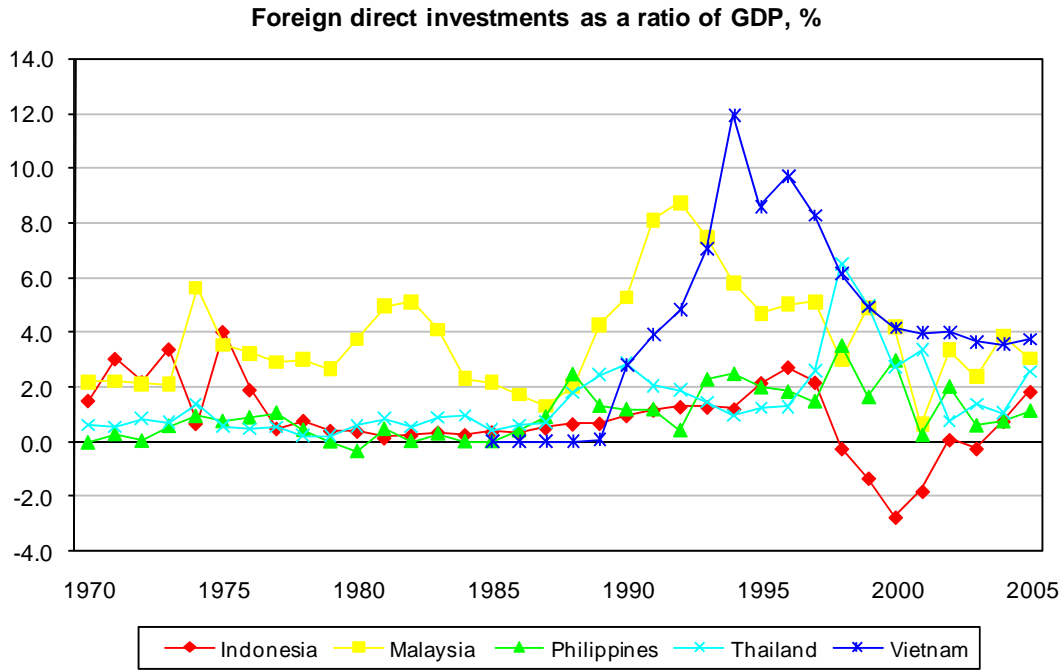
Authors' estimates.

Source: *World Development Indicators*.

### Current account balance ratio to GDP, %



Source: World Development Indicators



Source: World Development Indicators.