



Foreign aid and economic development in Indonesia

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ABSTRACT

It has been suggested that foreign aid can bring positive impact on economic development. However, in developing countries, such as Indonesia, the impacts of foreign aid program are mainly seen temporary. Instead, foreign aid has contributed to the growing of the real debt burdens. The lack of capital, however, should not be a reason for taking foreign aid in Indonesia. This problem is actually because the Indonesian Government is corrupt, inefficient and poorly managed.

INTISARI

Hutan luar negeri sering dianggap berdampak baik terhadap pembangunan ekonomi. Namun demikian di Indonesia sepertinya dampak tersebut hanya terlihat temporal. Beban hutang yang semakin berat justru terlihat dalam kasus utang luar negeri di Indonesia. Karena itulah kekurangan modal semestinya tidak menjadi alasan utama pemerintah memutuskan utang. Perbaikan tata pemerintahan yang bersih dari korupsi dan efisien adalah akar masalahnya.

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1. Introduction

There are a number of apparent relationships between foreign aid and economic development in Indonesia. Many economic development programs in reducing poverty were supported by foreign aid. The most obvious example in recent years is the Indonesia's National Program for Community Empowerment (PNPM). This four-year program helped to overcome on the lack of infrastructure, and improving local governance performance (Worldbank, 2013). Given that, it was assumed that the Indonesian government has achieved some of its economic development goals in short term mission.

However, if we try to look at this from a critical point of view, the overall consequences of this program are mainly seen to ossify temporary. Meanwhile, the long

term outcomes such as, self-reliance and improvement in citizens' income have not been achieved. Instead of reducing poverty, foreign aid has contributed to the increasing of the real debt burdens which potentially cause a greater dependency on the international aid. The Indonesian government would then have to pay back external debt maturing every year and has required the country to reduce the funding for social welfare.

This paper argues that, the shortage of capital and the problem of poverty should not be considered as the main catalyst behind the move toward foreign aid. Instead, in developing countries, like Indonesia, these two problems are actually driven by poor and corrupt government. The government has failed to raise substantial revenues and to formulate appropriate poverty reduction policies. Therefore, to overcome the external debt problems, debt relief is a necessity.

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Although there is a risk in implementing debt relief, it seems like the best solution to reduce the burden of debt payment.

Based on the discussion above, the purpose of this paper is to discuss the impact of foreign aid on developing countries and the reason why debt relief should be pursued. The paper consists of two main sections. The first section outlines the theoretical approaches to explain the main argument of this paper. The next section outlines a case study to elaborate the main argument which in this paper is Indonesia.

2. Theory

The issue of foreign aid effects on economic development has long been a subject of the debate. Chenery and Carter (1973) define the implementation of foreign aid into four assumptions. Firstly, foreign aid can be used to encourage investments and economic growth. Secondly, the amount of foreign aid will decrease as a consequence of economic growth achievement. Thirdly, foreign aid plays an important role in improving resource mobilization and structural change to reduce poverty rates. Lastly, in order to generate economic growth within foreign aid scheme, a strong foundation of production and trade are needed.

In contrast to Chenery and Carter, Temple (2011) argues that assessing the effect of foreign aid which based on economic growth has to be rather subjective because basically in developing countries, humanitarian aid achievements such as education and health sector are far more urgent priorities than economic growth. Moreover, Temple proposes that the idea of foreign aid to stimulate economic growth through investment due to limited domestic savings is completely misinterpreted. Although greater investments that are driven by foreign aid are useful to initiate growth, this scheme is not sufficient to produce the economic transformation needed.

On the other hand, there is also inconsistent with Chenery and Charter's argument which claims that the amount of foreign aid would decrease automatically after economic growth has been reached. As we know, the number of foreign aid has been increasing from time to time in developing countries. The politics of foreign aid, uncertainty of economic stability, and the slow increase in revenues force these countries to choose foreign debt as the main source of funding (Basri, 2004).

The controversy also occurs when it comes to poverty reduction. A number of researchers have reported that foreign aid has given significant impact on poverty reduction under any of the following circumstances, such as good policies and institutional environments (Collier and Dollar, 1999), the level of corruption

(Marjit and Mukherjee, 2000), and composition of aid matters (Alvi and Senbeta, 2011). However, the relevant question in this context is that whether the widespread poverty should be the main factor for lending. In this case, Temple's argument is again relevant in explaining behind the unrealistic reasons of foreign aid in developing countries. He (2011) suggests that the existence of poverty should not be the reason for foreign aid because poverty in these countries is associated with poor governance performance and rent seeking problems.

Turning now to the debt relief scheme, many scholars hold the view that it should be carried out by developing countries. According to Krugman (1988), the increase of debt would hinder economic growth due to overhang problems. This condition is described by Krugman in the "Debt Laffer Curve". Overhang occurs when the countries are not able to repay the debt because the total debts earning the maximum points. In this situation, countries have experienced a decline in efficiency. Krugman assumed that debt relief will push back efficiency and lead to reduce the risk of economic uncertainty.

Another positive impact is suggested by Cohen (1993) who argues that debt relief can enhance economic growth through encouraging the use of resources for productive investment. Then, the government will have the flexibility to manage their investment and public expenditure. In the same vein, Temple (2011) also points out that debt relief is the best method to increase the rate of investment. Debt relief will create economic stability, which ultimately can stimulate investment trusts.

However, there are some critics among scholars about the conditionality of debt relief. According to Serven (1997), debt relief will force the government to meet certain covenants. As a consequence, there is a future uncertainty that is resulting in lower local investment and failed to enhance economic growth. More broadly, Arslanalp and Henry (2004) claim that debt relief in the context of developing countries would not have a significant impact because economic institutions in these countries are very poor and unable to support domestic investments. In this case, debt relief would likely result in the uncontrolled entry of the external investment which can guide to the weakening in their economy.

Lesson learned from these literatures is that although debt relief has a certain benefit, there is also the risk. Hence, careful consideration about the capacity of macroeconomic performance and capability of economic institutions might be needed to avoid the failure of debt relief.

3. Research Method

This paper used descriptive qualitative analysis to elaborate how and why foreign aid policy in Indonesia taken place. In doing so, content analysis is used to understand the reasons and consequences of foreign aid policy in the country. The main data of this paper were come from official statistics and literatures.

4. Findings and Discussion

4.1. The impact of foreign aid in Indonesia

It cannot be denied that foreign aid is still a predominantly capital source in many developing countries. This method is often seen as an easy way to get funding in relatively short term. The latest data shows that the trend of foreign aid in developing countries continues to increase in recent years. The total external debt outstanding increased from \$4.4 trillion in 2010 to 4.8 trillion in 2011 (Figure 1).

This trend is also happening in Indonesia where external aid has increased continuously in recent years (Figure 2). This has made Indonesia as the top 5 recipient of the International Bank for Reconstruction and Development and International Development Association (Figure 3). Unfortunately, after being dependent on foreign aid, their external debt has not resulted in a substantial result in economic development. According to Chowdury and Sugema (2001), there is no strong relationship between external debt and economic growth in Indonesia (Figure 4). Instead of improving economic growth, the reliance on foreign debt has resulted in poor government. The government has no incentive to improve the country's revenue because they acknowledge their government would obtain sufficient revenue from foreign aid (Chowdury and Sugema, 2001).

Basically, in short term, foreign aid is actually an effective way to overcome the lack of capital rather than producing new money which result in the fear of inflationary. Government can also provide foreign aid to maintain the exchange rate to stay close to the target, in order to achieve higher investments and to get huge capital inflows. However, it is important to note that, as a Temple's argument which mentioned above, the idea of foreign aid would create some problems if its grounded in the limited domestic savings. This problem is exactly what happens in Indonesia. Low domestic savings has eventually caused heavy dependence on foreign aid, increasing debt repayment cost and disturbing macroeconomic performance in general.

It is reported that Indonesian public debt as a percentage of Gross Domestic Product (GDP) has reached 110 percent (Mulyani, 2001). The large amount

of debt makes the government not only bear the burden of repayments but also requires them to cover a deficit by getting new loans. What is worse is that this new debts are still not enough to cover all the interest of the previous debts (figure 5).

If foreign aid increases continually, the government would stay forever in debt, and would have only limited options to manage macroeconomic performances. Then, the possible impact that occurs is a reduction in the total amount of outflow. This means that the Indonesian government has very limited options to finance their country's development. In this case, the citizens are affected by the decline in expenditures for poverty eradication policies.

The impact of poor macroeconomic performance is extremely devastating, especially for the poor people. For example, due to potential deficit, the IMF has pushed the Indonesian government to reduce the fuel subsidies (World Bank, 2014). Afterwards, in November this year, the Indonesian president decided to cut the oil subsidies. As a consequence of the petroleum prices, there is a surge in food and transportation costs, as well as a higher inflation which causes negative impact on the poor. Based on this case, Krauss (1983) is probably correct because foreign aid is more likely to be a boomerang for developing countries. This is because the government deficit spending is always covered by foreign aid which led to the inefficient macroeconomic performance. Therefore, as far as Indonesia is heavily reliant on foreign aid, this state is likely to face a problem to enter the takeoff phase (Rostow, 1985)

Turning now the impact of foreign aid program, there is an indication that the foreign aid program has not contributed positively. PNPM program is the relevant example. In spite of the satisfactory result in the World Bank report, there are massive critics which argue that this program has not been able to address the real issue of poverty in Indonesia. The general critic and evidences are explained in the following details.

Firstly, the large amount of foreign debt leads to state budget constraints, which eventually become the responsibility of the entire society to repay through the tax scheme. Secondly, the PNPM program has not been able to reduce poverty significantly, the PNPM program is most likely a short term because the program is predominantly dominated by physical construction and as soon as the program is completed, the entire related scheme is closed immediately (Rosyadi et al, 2009). Instead of reducing poverty, the PNPM programs have caused financial losses. As reported by the Ministry of Co-ordination People Welfares (2011) between 2008 and 2010, there were approximately 4000 cases of corruption in implementing the PNPM programs with

the total of financial loss around 8,790,947 US dollars. Thirdly, the PNPM program has lack of knowledge concerning the real poverty situation in Indonesia. It might be because, as noted by Fisher (1998), the donor institution has tackled social issue through generalization without paying attention to the fact that the condition in developing countries is much more complicated.

Another research conducted by Arif (1998) which focus on foreign aid programs in general also shows that the penetration of foreign aid programs in Indonesia has not enhanced the citizens' own capabilities by hindering the growth of small businesses, upsetting the fishing industry, livestock and household handicraft industry. Similarly, a research from the Indonesia Corruption Watch (2009) also suggests that the contribution of foreign aid on poverty reduction is very poor. World Bank programs are often "sedative" to ossify temporary, for example, a Social Safety Net program which in reality has the potential to reduce social solidarity and self-reliance.

4.2. Debt relief: a necessity

According to the discussion above, I came to the final conclusion that foreign debt has not contributed considerably to poverty reduction and instead place more economic and political burdens to the government. Hence, encouraging debt relief program is imperative. As mentioned in the theoretical approach, debt relief is an effective way to overcome overhang problems and to stimulate investment. However, there is no doubt that the discourse of debt relief is still being debated. How to get a debt relief and what are the consequences if the government getting debt relief. Whether debt relief would be an alternative solution or creating new problems?

To answer this question, if we look at the debt relief record ever obtained by the African countries, Indonesia should be able to get debt relief because the level of dependence of Indonesia towards foreign aid is also high. The great challenge is how to build a connection and negotiation with the donor institutions. In this case, Indonesia can adopt Brady scheme. By this scheme, the bank provides debt relief with the high assurance of collectability as well as accompanied by economic reform commitment (Vasques, 1996). Brady scheme provides an opportunity for the debtor to negotiate their debt through financial investment schemes. In addition, Brady scheme also provides the opportunity to improve their financial capacity with the access of international capital markets. Although the Brady plan will not be able to guarantee that the government will get completely free from debt, but at least the government has the opportunity to negotiate their debts.

Another challenge that should be observed is corruption. It will be difficult to get debt relief, if Indonesia fails to make significant progress in the fight against corruption. Even, when the debt relief has been received, the government should be able to ensure that debt relief funds are not misappropriated. Maintaining the trust of donors, however, is a crucial thing in the debt relief process. After all, it is important to bear in mind that the debt relief is not without risk. If it is not followed by careful consideration, there is a possibility that Indonesia likely to have disadvantage, such as a problem in a political world or, in different case, the government required to sign the debt relief under certain conditions which are less beneficial for economic development.

Lastly, in spite of promoting debt relief, I also suggest that the government should pay more attention in generating income by increasing revenues from taxation. As Temple says (2011), the capital shortage in developing countries is mainly driven by poor and corrupt governments. This is precisely what has occurred in Indonesia, where the potential loss of tax reached 50 percent of the total target while among the main factor is actually a corrupt tax system (Perkumpulan Prakarsa, 2012).

5. Conclusion

Empirical evidence shows that external debts do not create positive impacts on the Indonesian economy, mainly because it leads to the increasing dependency of a country's revenue that causes the government to lose the opportunity for investments, as well as minimize the implementation of poverty alleviation program which is funded by donors. In the Indonesia context, the existences of poverty and capital shortage are in reality caused by poor government and widespread corruption. Therefore, a debt relief is a step that needs to be taken by the government to overcome overhang problems.

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