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FINAL PROJECT EVALUATION

THE INDONESIA DEVELOPMENT STUDIES PROJECT

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Glossary

Bappenas	Indonesian National Development Planning Office
BIDE	Boston Institute for Development Economics, co-contractor under DSP
BPS	National Statistics Office
DAI	Development Alternatives, Inc , co-contractor under DSP
DSP	Development Studies Project
EPSO	Economic Policy Support Office of USAID/Indonesia
GDP	Gross Domestic Product
GOI	The Government of Indonesia
HIID	Harvard Institute for International Development
HPAEs	High-performing Asian Economies (Hong Kong, Indonesia, Malaysia, Singapore, South Korea, Taiwan, and Thailand)
IMF	International Monetary Fund
Inpres	Presidential Instruction
ODA	Official Development Assistance, or highly-concessional aid by governments
NGOs	Non-Governmental Organizations
NPV	Net Present Value
REPELITA	Five-Year Development Plan
RMSM	Revised Minimum Standard Model, a macro model developed by the World Bank
UNDP	United Nations Development Program
USAID	U S Agency for International Development Office in Indonesia

Summary and Conclusions

I. The Project

The Development Studies Project (DSP) provided economic advisors and analytical studies for the Government of Indonesia between 1983 and 1995. The cost of the project was \$20 million. The project went through several design changes over its life. It was initially conceived as a financing facility for discrete studies of analytical issues identified by an interagency steering committee. In 1987, the project shifted from financing of studies to financing of a resident team of foreign advisors, assisted by short-term experts, to carry out major analytical studies in the areas of trade, employment, industry and regional economic analysis in support of Government of Indonesia (GOI) policy formulation, and was located in the National Development Planning Agency (Bappenas). In 1989, the scope of the project was refocused away from publishable studies and toward more directly policy-relevant work for the operating bureaus of Bappenas, often on a confidential basis. The project also provided assistance to the Central Bureau of Statistics (BPS). Services were provided by a combination of long-term foreign advisors resident in Indonesia, and short-term experts brought to Indonesia for specific studies. The project was implemented by the Development Economics Group, a joint venture between the Boston Institute for Developing Economies and Development Alternatives, Inc.

II. Evaluation Methodology

This is a final evaluation report on the DSP project, and was carried out by a three person team that spent three weeks in Indonesia in March and April 1995. The methodology used in the study included several approaches. First, the written output of the DSP project was reviewed, along with previous interim evaluation reports. About half of the 250 studies undertaken under DSP were studied. The team also reviewed the existing literature on evaluation of technical assistance projects, particularly with respect to methodologies for estimating benefits of economic advisory services and improved economic statistics. Second, twelve GOI officials intimately involved in the project were interviewed for their perspectives on the activities. In this process, a few studies of potentially high impact were identified. Questions regarding the impact of these specific studies were incorporated into subsequent interviews and analysis. Third, a variety of other people were interviewed, both inside the GOI, in private think-tanks, and among other donors to ascertain views on DSP in general and on specific studies that had been identified as high-impact. Altogether, the team interviewed over forty persons from Government of Indonesia users of DSP, from DSP staff (past and present), from the private Indonesian economic community, and from the donor/technical assistance provider community.

III. The Country Context

Until 1965, Indonesia's economy had stagnated for decades, both before and after its independence from colonialism in 1950. Since 1965, its economic performance has been one of the best in the world. The "economic miracle" of the last three decades has had dramatic effects on the quality of life of the people of Indonesia. Per capita incomes have tripled, average caloric intake has risen by 40%, life expectancy has risen from 44 years to 60, and the share of the population living in poverty by one yardstick has fallen from 60% of the population to under 15%. The improved performance was due primarily to the high quality of its economic policy. This policy in turn, reflected the combination of a small cadre of U.S.-trained economic technocrats with a stable and developmentally-oriented political leadership.

The Indonesian government's respect for economic analysis provided a positive context for the DSP project. The emphasis in government policy on increased efficiency provided a favorable environment for the use of economists to analyze national, regional and sectoral problems.

IV. The Role of Economic Advice and The Project Approach

While "good" economic policies are generally accepted as important to rapid economic development, there is an enormous gap between the analytical constructs of economists and the complex institutional, procedural, legal and political context in which economic policy is made in the real world. There is no real consensus on which principles of economics are most relevant to specific policy problems. Similarly, most would agree that economic analysis should support policy, but economic advisors have frequently been seen as either unable to influence policy or as espousing principles and approaches that are of little relevance to the problems facing policymakers.

This project experimented with approaches to analytical studies in support of better policy. It gradually and steadily moved from more "academic" studies to studies closely connected with, and for the purpose of directly informing the policy process. This progression increased the project's effectiveness over time, because it overcame the two common difficulties of "academic" studies: they fail to address real problems faced by government managers, and they are not packaged in ways that are likely to be understood by (or even read by) policymakers. By this view, the problem of expert advice is two-fold. The expert must be forced to understand the problems faced by the policy manager. This can only come from close observation. Second, the policy manager must invest significant effort in understanding the analysis of the expert.

The policy manager that the expert attempts to influence seldom makes policy directly. Government policy is the result of a tug of war among a variety of competing perspectives, interests, and perceptions. Most people participating in this tug of war will have views quite different from, and often hostile to, the analytical construct used by experts.

to convince their policy managers. For most practical policy problems, then, the prescriptions of the experts must be translated into terms or metaphors understood by practical men unwilling to defer to experts with arcane methodology and jargon. To be effective, such metaphors will be drawn from the analytical work of the experts, but interpreted and packaged selectively by the policy manager.

The DSP project achieved the intimate connection that helped policy managers be more effective for two reasons. First, senior managers at Bappenas spent considerable effort developing mechanisms to promote its use. Second, the American advisors were committed to being relevant to the needs of the Bappenas managers rather than to more academic pursuits.

V. Project Inputs and Outputs

More than 250 papers were written under the project. The great bulk of these studies were completed after 1987, when the focus of the project shifted from financing of discrete studies to use of a resident advisory team. During the resident phase, the project provided about 40 person-years of long-term advisors and 12 person-years of short-term advisors to the Government of Indonesia.

The link between individual studies and policy changes is tenuous at best. As discussed above, policy usually flows from the interaction of competing perspectives, interests, and expectations in a world fraught with uncertainties. Nevertheless, some studies under the project opened peoples' eyes to particular matters that changed the nature of the debate in constructive ways. For example:

- A study of the non-traditional export boom on Bali provided a new perspective on the benefits of foreign investment by small firms, and helped create the favorable climate that led to liberalization of investment and travel restrictions on foreigners.
- Improved statistics from a "backcasting" exercise identified more correctly the relationship between GNP growth and demand for electric power. The revision of historical data on manufacturing growth (which nearly doubled the rate of growth of output) led to downward revision in projections for electric power generating requirements, substantially reducing new investment requirements.

Despite the impact of particular studies, they were only one of a variety of channels by which the project affected policy, and thereby economic outcomes, in Indonesia. Policy improvements came from a variety of directions in which the project was active, including

- specific study results, as described above,
- informal discussions with policy managers which led them to new perspectives on the structure of the economy,
- organizational improvements, such as the establishment in Bappenas of working

- groups, pioneered by the project,
- closer linkages between the basic economic facts of the country and the policy process, promoted by the BPS work and the new links established between BPS and Bappenas,
- development of models to assure *ex ante* consistency among macroeconomic goals of the government, and
- increased decentralization of decisionmaking, promoted by the project

VI. Major Conclusions

1 The basic conclusion is that the project was **an extremely effective development assistance activity** that brought very large benefits to Indonesia. These benefits accrued in improved economic policies that flowed from the close collaboration between the economic advisors and dedicated Indonesian government officials. A crude estimate places present value of benefits of the project at \$492 million, compared to a cost of \$21 million.

2 The project significantly improved Bappenas' productivity in making sound economic policy decisions in several areas:

- **the economic model upgraded Bappenas' capability** to ensure consistency among macro aggregates, and it improved overall GOI decisionmaking on macroeconomic issues, particularly with respect to the budget,
- **the policy advice and short-term studies armed policymakers with sounder basis for decisions.** There are real difficulties in identifying specific impacts, but policy areas where the project provided input that seems to have improved (or prevented deterioration of) GOI policy include trade, regional development, allocation of INPRES funds, regulation of foreign investment, health and education policy, and rural credit reform, and
- **the BPS assistance significantly improved the quality of the basic factual basis for policy decisions.** This supported improved policies.

3 The *quality* of AID-provided experts and the confidence placed in them by host government officials were the keys to success of the DSP advisors. The size of the resident team (4-6 people) was appropriate.

4 The DSP contribution is most unique in improving quality of statistics. The GOI, other donors, economic researchers, and the private sector all have benefitted from the "informational public goods" created by this aspect of the project. The linkage between producers and consumers of statistics encouraged better statistics production.

5 The technical assistance provided under the project appears to have been unusually

productive This seems to trace to several factors

- high-quality BAPPENAS counterparts, due to advanced training in U S ,
- strong BAPPENAS input and management,
- strong sense of purpose by advisors,
- triangular interaction between DSP, USAID and BAPPENAS,
- effective means for developing good relationships between long-term advisors and BAPPENAS staff, and
- effective project management by USAID, including active involvement of economists in EPSO

6 The project also contributed to the effectiveness of the rest of the USAID portfolio

- it gave the Mission's Economic Policy Support Office (EPSO) closer touch with economic policy issues, contributing to AID's ability to design an appropriate mission strategy,
- it provided EPSO staff and mission management with opportunities to work closely with senior Bappenas staff, thereby creating opportunities for policy dialogue and greater responsiveness to key GOI needs, and
- it provided linkages to Bappenas in the technical sectors where AID had projects, thereby strengthening AID links to policy formation in those sectors

VII. Principal Recommendations

For USAID/Indonesia

1 USAID/Indonesia should seek to ensure continued presence of a foreign advisory team in Bappenas at least until the fate of the proposed follow-on advisory project by the Asian Development Bank is determined. Continuity of the process established by DSP is key to the effectiveness of any follow-on arrangement

2 Advanced training in the U S for Indonesian economists has complemented the DSP, and has been helpful to its success. Returned Ph D 's are playing a key role in Indonesian economic policy, and USAID funding for such training should continue

3 USAID/Indonesia should seek ways in which informed public debate on economic issues can be promoted. As Indonesia becomes more developed, more aspects of the economic policy debate will inevitably move out of the internal government sphere into public fora

For AID/Washington

1 AID/Washington should reconsider its withdrawal from the economic policy process in developing countries. In the right country context, economic policy advisory projects are a low-cost activity that has potentially high payoffs.

VIII. Lessons Learned

1 Economic advice can be a very high payoff activity for AID missions. The Indonesian experience suggests that long-term advisors who have access to and can gain the confidence of economic policymakers are important to this result.

2 Economic advice need not be linked to external resources, or conditionality to be effective, indeed, some of the effectiveness of the DSP resulted from the perception that the advice was objective and independent of other donor goals.

3 Government economic statistics are a neglected area for donor assistance. Improvements in the quality of such statistics can have important economic payoffs. The project included (a) working to strengthen the existing statistical apparatus, and (b) strengthening links between producers and users of economic statistics. Both elements were valuable in achieving permanent and sustained improvement in statistical information.

4 AID Missions should be cautious in supporting large economic models intended to help recipient government economic policymaking. Such models are likely to be very demanding in technical input and data to provide useful policy-related results. Simple models are to be preferred. If use of a simpler approach demonstrates the need for more sophistication, this should be pursued gradually and incrementally.

Chapter 1 Introduction

Donors have long tried to get economic policy reform by conditional assistance. World Bank and IMF loans, and AID grants have been "tranching" so that funds flow when specified economic policy changes are made. From the lender's perspective, conditionality is easily explained. The donor wants to ensure that the resources are used effectively, and not wasted on some futile or ineffective or corrupt purpose --e.g., defending an overvalued exchange rate. From the recipient's perspective, however, conditionality is more problematic. If the policies espoused by the lender are good for the country, why does the government have to be forced to implement them? Would they not want to adopt such policies, even absent any donor help?

The frequently-used defense of conditionality is that improved policies pay off in the longer term, but they usually have some short-term costs. In essence, then, the recipient government is compensated for short-run costs associated with policy improvements. The conditionality game, nevertheless, creates some undesirable dynamics.

The alternative of providing technical assistance for policy advice to governments without any link to conditioned assistance has been utilized much less. But with declining USAID budgets and reduced ability to provide significant resource transfers, the option of transferring policy advice only needs to be explored. USAID/Indonesia has pioneered in providing technical assistance for policy advice. Hence, there is considerable Agency interest in learning from the Indonesia experience.

USAID is a marginal donor in Indonesia, providing about 3% of donor funding, or around \$60 million per year. The World Bank, the Asian Development Bank and the Japanese Government each provide more than \$1 billion per year. Since 1987, USAID/Indonesia has provided economists to do studies and provide advice to the Indonesian Government under its Development Studies Project (DSP). Since the project is not linked to any larger sums of money, the effectiveness of the assistance is purely dependent upon the usefulness of the studies in convincing the Indonesian government that proposed reforms are in Indonesia's interest.

James Fox, senior economist in USAID's Center for Development Information and Evaluation and James Walker, chief economist of USAID's Bureau for Asia and the Near East, and K C Delhotal of Devtech, Inc., evaluated the DSP project during March and April 1995, with the following questions in mind:

- Did the project succeed in improving economic policy in Indonesia?
- Can an economic value be placed on the studies and advice under the project?
- What were the strengths and weaknesses of the design used in the project?

- Was policy advice effective without being linked to money?
- Does AID have a comparative advantage in such projects, or should they be left to the World Bank and IMF?
- Should AID consider funding similar projects in other countries?

The team interviewed some 46 people in the United States and Indonesia in March and April, 1995. These included 16 direct users of DSP in the Government of Indonesia, 14 economists from past and present DSP staff, 12 people from the donor community, and 4 Indonesians outside government who were knowledgeable about Indonesian economic policy issues. (Appendix 4 provides a list of interviewees.) About half of the studies undertaken under DSP were also reviewed, as was project documentation and previous evaluations. The team also reviewed the existing literature on evaluation of technical assistance projects, particularly with respect to methodologies for estimating benefits of economic advisory services and improved economic statistics.

The report is organized as follows. Chapter 2 describes the project and its implementation, Chapters 3 and 4 offer perspectives on the role of economists in the policy process and on the Indonesian policy context, Chapter 5 summarizes the policy and institutional impacts of the project, Chapter 6 discusses factors affecting project effectiveness, and Chapter 7 gives conclusions and recommendations for the future.

Chapter 2 Review of Project Implementation

2.1 DSP I Inter-Agency Research Fund

The initial Development Studies Project (later called DSP I) was authorized in June, 1983. It was intended to respond to a need for better economic analysis in the context of the need to diversify the economy and to rely less on oil income. The project was intended to create a link between policy analysis and policy formation through studies, seminars, experiments, and publications. Policy makers were expected to benefit by

- an improved knowledge base for making decisions,
- broadened understanding of the implications of decisions taken,
- reduced risk of poor or untimely decisions, and
- increased sensitivity to the growth and equity effects of alternative policies

The project funds were used mainly for small research activities, most carried out by Indonesian researchers. By design, none of these activities cost more than \$200,000. The project was initially funded by a \$3 million grant from USAID and \$1 million from the GOI. In May of 1985, USAID added another \$1 million, and the GOI added \$400,000. By the time of the project redesign, \$3.5 million of the \$4 million USAID total had been committed to subprojects.

A GOI Steering Committee, including senior officials from the Ministry of Finance, the National Development Planning Agency, and other ministries, reviewed proposals against a pre-established set of criteria. Some 130 proposals were received, of which 29 were approved. A number of the studies covered aspects of the new Five Year Plan (Repelita IV). The Repelitas have provided the basic framework for GOI investment programs. Other projects provided a variety of government agencies with access to research funding.

The large number of project requests submitted suggests substantial interest in the project. The steering committee discussions also provided a forum for discussing and identifying priority policy research needs. Nevertheless, some of the studies were criticized as too theoretical, or too difficult to translate into policy initiatives. Some foreign experts brought in to do studies were seen as insufficiently familiar with Indonesian conditions to relate their theoretical constructs to current Indonesian development problems. In addition, the project selection process may have generated interesting-sounding proposals that lacked direct relevance to policy issues. Some participants in reviews of proposals found that the review process was as useful (if not more useful) than the studies being reviewed. The discussions were seen as promoting conceptual thinking about policy issues.

2.2 DSP II Overview

In 1986, USAID/Indonesia and the GOI reviewed the progress of the project and concluded that the studies were not producing the right mix of policy relevance and analytical rigor. The limit on individual subprojects precluded use of long-term experts, limiting the project's ability to strengthen institutional capacity. The project was redesigned to operate much closer to the policy process. The assistance provided was to shift from specific studies to a set of policy areas, for which a mix of long-term advisors and short-term consultants would provide studies and expert opinions. BAPPENAS, the National Development Planning Agency, would manage the project, which would operate as a "think tank" within the ministry, and provide a long-term advisor to the national statistics office.

DSP II went through two distinct phases. The first phase, designed in the project paper, focused on building a foundation of solid analytical research, much of it to be publishable, and improved data collection on Indonesia, but not necessarily linked to immediate economic decisions. Attention was to be given to current economic policy issues, but a shelf of solid studies was also contemplated, to be available "on the shelf" for later use when specific policy decisions arose. Studies were generally expected to be publicly available. In 1988, a shift in BAPPENAS management led to a redesign of the project. This second phase shifted the focus away from publishable research to more directly policy-relevant work for the operating bureaus of BAPPENAS, often on a confidential basis.

2.3 Phase One: The Think Tank (June 1987-August 1988)

In 1987, a four-year contract was signed with DAI (Development Alternatives Incorporated) and BIDE (Boston Institute for Developing Economies), with the intent of an additional two-year non-competitive extension if the project proceeded successfully. BIDE and DAI were to provide the advisors to staff the research center or "think tank," which would build an institutional basis on which good policy decisions could be made. The original technical assistance team saw the project as a vehicle to build data bases, conduct economic research, prepare groundwork studies, provide training for young researchers, and facilitate policy dialogue. Well-known experts from various fields would be used as short-term consultants, both to bring their expertise to bear, but also to familiarize leading U.S. academics with Indonesia. The DSP II workplan focused on research on industry, employment, and trade, and on technical advice on statistics.

In this phase, DSP consultants' primary contacts were with three of the Deputy Chairmen in BAPPENAS: the Deputy Chairman for Economic Affairs, the Deputy Chairman for Fiscal and Monetary Affairs, and the Deputy Chairman for Human and Natural Resources Development. These three, along with representatives from other parts of BAPPENAS and other ministries, were members of a steering committee that guided the direction of the research. In the first three months of DSP II, a research agenda covering several years was constructed with the approval of the Project Steering Committee.

The "think tank" design created an academic environment conducive to producing high quality, high value research in a relatively short amount of time. The researchers involved felt that it was a highly-productive environment for academic thought and performance. Several U.S. academics that worked in DSP during this period characterized it as the most stimulating and productive period of their lives. However, this analytical work did not track very closely with BAPPENAS' operational policy concerns. Moreover, the BAPPENAS counterparts who were to work with the U.S. researchers were able to spend little time on DSP studies because of continuing responsibilities at BAPPENAS.

Table 2.1

DSP II Studies by Year and Type

Type of Paper	1987	1988	1989	1990	1991	1992	1993	1994	Total
Research Memos	9	32	2	7	10	20	15	7	102
Statistical Papers	1	17	6	6	6	4	6	6	52
Planning Documents	1	3	2	1	2	6	3	5	23
Special Papers	2	5	1						8
Research Papers		8		2	1		1	7	19
Policy Memos		6		2	4	8			20
Statistical Memos	—	—	—	<u>1</u>	—	—	—	—	<u>1</u>
Total	13	71	11	19	24	38	25	25	226

Funding for this phase was approximately \$1.3 million. This covered four resident consultants, support staff and 14 short term consultants. The team produced 61 research papers, statistical papers, research memos, special papers, and policy memos and provided internships for BAPPENAS staff.

In addition to the above studies, the DSP team began work on development of a computable general equilibrium (CGE) model in BAPPENAS to be used in policy decisions. After considerable time and effort, it was concluded that the model was likely to be too complex and too demanding of updated data to be maintained on a regular basis.

A team member was also assigned to the Central Bureau of Statistics (Biro Pusat Statistik, or BPS) for a trial year in the Bureau of Analysis and Methodology Development under the Deputy Director General for Planning and Analysis. The consultant assisted the bureau with data improvement and analysis. In particular, the DSP consultant was assigned the task of setting up an informal data evaluation process to analyze the quality of data for the industrial sector, employment, wages, and national accounts. Training programs and data bases were developed as the situation evolved. This led to an additional DSP resident expert assigned to consult with BPS in 1990.

During the first phase, most papers were publicly available, but the distribution of two research papers and one special paper were held up by BAPPENAS officials as involving highly sensitive issues

2.4 In Limbo (September 1988-February 1989)

A new administration took office 10 months into DSP II. A new head of BAPPENAS was chosen, and many of the deputy chairmen changed. The new leadership felt uncomfortable with the role DSP played in the Ministry. In particular, the new Minister felt that the DSP advisors were too visible and not responsive to the short term policy needs of the Ministry. One paper published by a leading DSP researcher, critical of some Indonesian economic trends, also created concerns about the desirability of publishing under the project.

The project went into limbo at this point. Work continued on studies initiated before September 1988, but new studies were held up except for a few small projects. Funding for this phase of the project was approximately \$900,000. The statistical assistance was allowed to continue. Despite the lull in relations, 22 research reports, statistical papers, or research memos, policy memos, and special papers were completed. Eleven short-term researchers came to Indonesia to do specific work.

The statistical advisor in BPS was not affected by the Bappenas problem, and his relations with BPS developed smoothly. Training exercises, data base and survey design improvements, and data improvement activities continued without interruption.

2.5 Phase Two Internal Policy Studies (March 1989- June 1995)

In 1989, BAPPENAS and USAID redesigned the project, creating a more closely knit and more confidential working relationship between DSP and the three deputy chairmen in BAPPENAS. The DSP team focused on becoming much more integrated into the Bappenas structure, providing information on urgent policy questions and utilizing the infrastructure built up in the first phases. Fire-fighting and speech writing replaced some of the long-term projects. Contacts with officials outside BPS and BAPPENAS were reduced. Publication of policy advice and papers was restricted.

The CGE model and other macro-econometric modeling efforts were abandoned for a much simpler macroeconomic model adapted from the World Bank's revised minimum standard model (RMSM). The RMSM was adapted to Indonesian conditions and installed by DSP II consultants to forecast different budget scenarios. GOI officials have found this model practical and useful in its day-to-day operations, and have taken over its management from DSP.

Though the operating style of the project changed from a more long term view to a short term view, the purpose did not. The team continued to assist BAPPENAS in

examining policy issues in the area of employment, industry, and trade DSP II was specifically set up to assist BAPPENAS The emphasis was to be flexible in responding to the needs of the Indonesians (Project Paper, June 1986) During the first phase of DSP II, the Ministry officials could not digest the sheer number of studies produced Trained economists were in short supply within BAPPENAS and their time was stretched among many activities BAPPENAS needed to strengthen its own research and analysis capabilities, while covering the gap in the short term with the DSP II advisors DSP II filled this gap with analysis on immediate concerns, in addition to helping build up BAPPENAS's own capabilities through working with the professional staff The contractor demonstrated considerable flexibility in adapting its operations to the changed conditions This contributed substantially to the project's eventual success

An important feature of the new design has been the collaborative research conducted through working groups These working groups have consisted of DSP consultants and BAPPENAS staff Examples of these working groups include a working group centered around the macroeconomic model and a working group researching rural credit systems Working groups and task forces were the main mode of methodology transfer from the DSP team to BPS and BAPPENAS staff In addition to these collaborative efforts, DSP consultants worked with Indonesian research assistants from BPS and, for the first year, from BAPPENAS

Funding for the second phase of DSP II totaled \$13.6 million Some 120 research memos, policy memos, special papers, research papers, and statistical papers have been produced in this phase Topics covered trade, industry, urban development, and employment

DSP technical assistance to BPS continued to be very successful during this phase Besides expert advice, it included training seminars for BPS staff, transferring technology/methodologies to BPS

2.6 *Quality and Cost of Inputs*

Senior Indonesian officials considered the project as having been successful, both in terms of the quality and responsiveness of the DSP II consultants, and in institution building at BPS and BAPPENAS Most DSP consultants developed close professional relations with senior Bappenas staff, and GOI officials were enthusiastic about the quality and responsiveness of the DSP professionals

During Phase II, the project included between two and four long-term consultants, all Ph.D.'s in appropriate fields with extensive experience in consulting either with a firm or a major donor or both The short-term experts had doctorate degrees in appropriate fields and had extensive experience in their fields In many cases, the experts had considerable experience in Indonesia as well Some short-term consultants were specifically requested by BAPPENAS officials The team was also assisted by research assistants who attended

Ph D programs in the U S after their experience with DSP

Approximately 20 BAPPENAS staff members were trained in the development and use of the macroeconomic model, which plays an important part in the preparation of the REPELITA Three BPS officials have also been trained in survey design and statistical models and methodologies, including staff in regional offices

Project costs appear to have been reasonable in terms of the expertise provided The direct cost, including salaries, fringe benefits, travel and transportation, allowances and per diem, and other direct costs is estimated to be approximately \$14,200 per person month for the field consultants Including overhead and other project support costs, the total cost per consultant month in Indonesia is estimated to be around \$25,000 Project costs associated with purchase of equipment, including vehicles, data processing and office equipment, and library materials appear to have been reasonable

Chapter 3. What Does Economic Advice Do?

3.1 *The Impact of Policy on the Economy*

Does economic policy matter? Over the longer term, the evidence strongly supports an affirmative answer. Nations have risen and fallen based on the climate they provided for accumulation of capital and production efficiency. The rise of Western Europe after 1500, when China was far more advanced in both technology and political organization, has been explained as a result of differences in economic policy frameworks¹. The recent rise of some nations (e.g., the high-performing Asian economies) and the stagnation or decline of others (e.g., the former Soviet bloc, Argentina, much of sub-Saharan Africa) is seen by economists as evidence of the central importance of policy.

Indonesian experience also confirms the generalization. There was little difference in basic national goals between the Sukarno (1950-66) and Suharto (1966-present) regimes. Both were nationalistic and suspicious of foreign influences. Both sought to lead Indonesia to a place as an eventual world power. Both believed in mass education and sought to improve the conditions of life of the poorest Indonesians. Both saw the state as the lead actor in national development. Both were suspicious of unfettered capitalism, which both feared would benefit foreigners and the Chinese minority at the expense of the majority. Their difference was fundamentally in the types of economic policies used by the two leaders in their pursuit of similar national goals. Sukarno's view, articulated in an 'I Hate Economists' speech² to the student body of the University of Indonesia, was that the concerns of orthodox economists were irrelevant to Indonesian needs, and that only Marxist economics was useful. Suharto, on the other hand, relied importantly on the prescriptions of a small group of U.S.-trained economists.

The contrast in performance was stark. The Sukarno period was disastrous for the realization of Indonesian goals. Per capita incomes fell significantly, inflation took hold, and, by 1964, which Sukarno called the "year of living dangerously," economic calamity, serious food shortages, and political crisis were at hand. During the subsequent three decades, dramatic improvements in the conditions of the average person have occurred. Per capita incomes have more than tripled. By one yardstick, the share of the population living in poverty has fallen from 60% to under 15%. Average caloric intake has risen by 40%, and life expectancy increased from 44 years to 60.

¹See, for example, Nathan Rosenberg and L.E. Birdzall, **How the West Grew Rich**, for a description of the development of an institutional environment favoring growth in Western Europe after 1500.

²See Glassburner (1991).

3.2 *Policy Reform, Maintenance and Decay*

While economic policy is critical to long-term growth, there is no hard-and-fast or unambiguous linkage between the quality of economic policy and economic growth results. It is the ambiguity and the complexity that leads to the wide diversity of policies pursued by governments of different countries. The reason that some governments pursue approaches that bring negative consequences in the longer term is surely that they are mistaken in their perception rather than that they purposely intend to prevent growth.

a Why Are Economists Needed?

It is easy to say that economic policy is the key to growth. This does not necessarily create a need for economists. One could simply pick up the latest prescriptions offered by the World Bank and follow them. The basic recipes are relatively simple (though they do change somewhat over time): keep government focused on key public goods like a stable legal framework, and maintenance of public order, with government spending focused on key investments like mass education and infrastructure, keep open to the world economy, with a unified market-determined exchange rates, low tariffs and no restrictions on foreign investment, promote private production and marketing of goods and services, with government involved only to provide a legal framework and to promote competition.

Governments, however, are unlikely to ever follow such a set of principles, for two reasons. First, no government is likely to follow blindly a set of rules espoused by foreign economists. Second, governments cannot refrain from governing. Even if government leaders believed the prescriptions of foreign economists, public opinion would force government action on a wide variety of economic concerns. The public is far less convinced than academic economists of the value of long chains of deductive reasoning, or of the desirability of following abstract models in seeking the public good. In the modern age, governments have to take direct action on economic issues simply to demonstrate concern for the needs of the population. In other cases, intervention to strengthen or encourage major economic institutions or sources of employment usually gains widespread public support, even though the effect is often mainly to protect the status quo, and existing interests, rather than to promote greater wealth.

Given that governments do act in a variety of ways to affect the operation of the economy, what role do economists play in this process? There seem to be two main contributions of economists in the policy formation process:

1 Resource Limitations and the Need for Choice

Perhaps the most serious failing of governments in developing countries has been the unwillingness to recognize the scarcity of their resources. Well-intentioned governments have utterly failed to promote development or to improve basic social

conditions because they failed to choose. By trying to accomplish too much, they achieved too little. Government spending was not consistent with government revenues, so inflation accelerated, or the spending was not consistent with the balance of payments, so that foreign exchange shortages appeared. Governments often refuse to face the fact of policy inconsistency, and attempt a variety of complicated regulatory approaches to control the inconsistencies. Such actions create distortions, and opportunities for economic "rent-seeking," which lead to further regulations to deal with the inevitable failings of the initial regulations. Ultimately, the regulations prevent economic growth, which in the long run slows the possible growth rate of government spending on social programs. Economists act as the guardians of prudent management of scarce resources.

2 Understanding Connections and Unintended Consequences

The second contribution of economics is the recognition of the "connectedness" of the economy. Every action by government leads to actions elsewhere in the society that may reinforce, or attenuate, or negate the effect of the governmental action. This means that government actions may have unintended consequences, where the real effect is starkly different than the original intention. For example, wheat subsidies in Egypt, intended to ease the poverty of urban consumers, probably increased the poverty of the poorest Egyptians -- those growing food -- while increasing rural-to-urban migration. Government approval requirements for new industrial investment in India, intended to increase the productivity of capital by preventing excess capacity, actually reduced productivity of capital and increased excess capacity. And everywhere, hoarding of essential commodities is most evident where governments are most resolute in preventing hoarding.

It is in this area where the analytical role of economists is important. They attempt to "model" the economy by simplifying its myriad interactions into a few key relationships, and to draw the implications of the behavior of the relevant actors. While imperfect, the economists' models have the virtue of being more consistent and more predictive than the alternatives. In analyzing the economy, economists typically

- assemble relevant facts and experience
- analyze longer-term implications of immediate actions, and
- evaluate alternative approaches

It is these kinds of activities that provide the "bread and butter" for economists. They can pronounce on broad policy questions, but their more frequent contribution is in the careful analysis of the consequences of narrower policy questions or specific projects.

b Policy Maintenance

Experience suggests that sound economic policy is not self-maintaining. The quality of economic management will gradually decay unless active steps are taken to prevent this. This suggests that economists can be valuable even where policy improvements are not

being made, they prevent policy deterioration. In the case of the United States, Ronald Coase has made the calculation that an economist could save society an amount of money equal to twice his lifetime salary by delaying for as little as one week the adoption of a policy that would decrease national income by \$100 million.

Policy decay seems to spring from two directions. First, there is a continuing stream of new ideas or short-cuts to national nirvana being proposed. Political leaders are daily treated to proposals that are identified by their proposers as likely to generate large benefits to the nation at only small costs. Such schemes often create special privileges for particular groups or individuals. Government favors sought by firms or individuals typically include preferred access to public funds, higher prices for the favored one's output or lower prices for its inputs. Though such schemes are almost certain to benefit their promoters, their effect on the nation is often negative. Instead of large benefits for few costs, the nation is saddled by few benefits for large costs. Moreover, the beneficiaries tend to be concentrated among a few, while the losers are dispersed, so the mobilization of effort to maintain such privileges even when their value comes into question is often large. Mancur Olson has termed "demosclerosis" this tendency for countries to steadily acquire a variety of special privileges that serve special interests at the cost of the nation. He argues persuasively that such "barnacles" are easy to acquire, but hard to eliminate. As a consequence, democratic governments with long periods of peace will become progressively less able to grow and adapt to changing world conditions.

Second, the idea of "economizing" is inherently unpleasant, and politicians hate to do it. They are willing to listen to their economic advisors when times are tough. During general prosperity, however, there is a tendency to believe that hard choices no longer need to be made -- that the bountiful future will provide sufficient resources for all good things (The chronic budget deficits of the United States trace in significant part to spending decisions made in the 1960s and early 1970s (e.g., entitlements, double-indexation of social security), that though small at the time, and nippable in the bud with no significant political cost, grew to be giant problems to be addressed only by the most committed budgetcutters).

Thus, the role of the economist is not simply to raise the rate of improvement in national wealth. It is also to prevent deterioration of the national capacity to generate new wealth.

3.3 Role of Ideas, Government Leaders and Public

The linkage between good economists and good economic policy is not automatic. England had the world's best policy-conscious economists between the two world wars, but this did not prevent bad policies, including maintenance of an overvalued exchange rate. Indonesia, with only a few well-trained economists, avoided this error.

Nowhere is the advice of economists accepted uncritically by political leaders. Such leaders draw their ideas from a broad vision of the problems of society and their role in

dealing with them. For example, the differing growth outcomes in the high-performing Asian economies (HPAE's) and countries in Latin America and Africa is probably due in part to differences in broad concept of their situation. The HPAE's each faced serious external threats, and their leaders perceived their country as extremely vulnerable, and their prospects as dependent on careful husbanding of economic resources and great concern for growth.

On the other hand, governments in Latin America and Africa during the 1960s had a much more expansive view of their historical circumstances. They widely accepted Walter Rostow's "take-off" -- probably the most popular metaphor (or model) in the history of economic development. In two words, it characterized an approach that was widely adopted by developing-country governments in the 1960s and 1970s. Government simply had to -- by whatever means at its disposal -- get the economy 'moving' fast enough to overcome the forces of tradition that were impeding development, and modernization would become automatic. The economy would take off into sustained growth. This provided the rationale for governments to ignore previous concepts of financial prudence, to build and operate factories or steel mills, or to use the tax and subsidy power in scattershot attempts to promote movement.

The power of the metaphor was not in the logical arguments or empirical data in Rostow's book. Indeed, such evidence is almost totally absent, and development economists were almost universal in their rejection of this 'theory'. He did capture, however, the can-do optimism of the 1960s. This metaphor may have done great damage to the policy process in developing countries by implying that development was virtually automatic once a certain stage was reached. The experience of developing countries after 1975 demonstrated clearly that economic development was far more difficult than the metaphor implied. Those countries that were most successful during the last three decades -- the high-performing Asian economies -- were instead fixated on their vulnerability and the tenuousness of progress.

In dealing with broad questions of vision, the role of the economist is to help the policymaker choose among alternatives, identifying those that have more basis in logic, history and experience, and rejecting ideas that -- however enticing -- lack it.

3.4 Role of Expert Consultants

Economic policy in most developing countries, and certainly in Indonesia, is in the hands of national government officials. Nevertheless, the lack of human capital means that those with advanced training in economics can command senior government positions. While having the training for careful economic analysis, such officials lack the time to do it. As in other countries, the policymaker is faced with the need to make quick decisions, to make policy where great complexity is involved, where non-economic factors are significant, all the while lacking staff to analyze these questions carefully. These needs provide a role for the expert consultant. The role of the expert is thus to *increase the*

productivity of the economic policymaker by increasing the quality of his decisions The policymakers become more productive because

- they (indirectly) think through alternatives more completely,
- they are able to assemble more relevant facts,
- they bring more experience to bear on problem,
- they think about the consistency with other goals, and
- they are able to articulate a coherent position more clearly and concisely

Thus the foreign advisor's impact on policy is indirect The advisor operates through other individuals, so it is not possible to separate the advice or insight of the advisor from the policymaker's own thoughts or from other influences Consequently, assessing the impact of a policy advisor is difficult One arrives at a judgment based on several types of observation

- Did the economic advisor have frequent access to policymakers?
- Did the policymakers value the services of the policy advisors?
- Did decisions made by the organization appear to have improved in quality during the tenure of the economic advisors?
- Did the organization implement policies consistent with those espoused by the advisors?
- Did the organization increase its use of economic advisors, or to institutionalize advisory techniques?

Chapter 4. The Indonesian Policy Reform Context

4.1 Introduction -- Indonesia in 1965

Indonesia's economic performance since 1965 has had little precedent in either previous history or the expectations of economists in the mid-1960s. A leading economic development textbook from that era describes Indonesia as follows:

Indonesia must surely be accounted the number one economic failure among the major underdeveloped countries. No other large and populous country presents the same stark picture of prolonged economic stagnation, persevering throughout centuries of colonial rule and continuing throughout a decade and a half of independence. Stagnation -- in the form of virtually constant levels of per capita income or an unchanging structure of employment and production or both -- is certainly not unknown among underdeveloped countries, but the Indonesian experience, in which a whole series of concepts of economic organization, first in a colony and then in an independent nation, failed to bring significant or lasting improvements in levels of living at any time, seems to be unique.³

Nor was this economic stagnation all. Some saw Indonesia in far more apocalyptic terms. Java had 68 million people in 1965. This population density more than 500 people per square kilometer made it appear to be a Malthusian trap. Some experts argued that Java was undergoing an process of "agricultural involution" whereby increased amounts of labor applied to rice production yielded steadily diminishing returns (Geertz, 1963). By this argument, Java had no means for achieving the capacity to feed itself, or to avoid eventual mass starvation (Keyfitz, 1965).

4.2 The Performance Record

Indonesia's economic growth rate since the time of those dire predictions has averaged nearly 7% per year. Per capita income rose by 4.3% per year, from \$207 in 1965 to \$884 in 1994, both measured in 1992 dollars.

The record on poverty reduction is even more impressive. By one poverty standard, the proportion of Indonesians living in poverty fell from 60% of the population in 1965 to 14% in the early 1990s. Other poverty cutoff lines would yield different percentages, but all show the same dramatic decline (see Booth 1993). By the mid-1980s, the country had moved from being the world's largest importer of rice to self-sufficiency at average rice consumption substantially higher than that of the mid-1960s. Per capita calorie consumption rose from around 1800 calories/day in 1965 to 2600 calories/day by the late

³Higgins (1968), p. 678

1980s Primary education was also promoted heavily, and nearly universal primary school enrollments were achieved by the late 1980s

4.3 Sources of Indonesian Economic Performance

A variety of factors contributed to Indonesian success. Political stability is one factor. One man has been at the top of the political system since 1965, endowing the country with policy stability. Of course, numerous other developing countries also had such stability over roughly the same period without achieving similar results (e.g., Cuba, East Germany, North Korea, Paraguay, Tanzania, Zaire).

Indonesia was also favored by large deposits of oil and natural gas, which dramatically boosted its export earnings in the 1970s. Yet Indonesia is almost alone among the major oil exporters in avoiding a major decline after oil prices began to fall in the early 1980s. Other major oil exporters (Mexico, Nigeria, Iraq, Iran, Algeria, Ecuador, Venezuela) all had to make, or even today are continuing to try to make, adjustments to resume economic growth.

While political stability and a large natural resource base may have contributed to Indonesian economic growth, they also characterized Indonesia during the long stagnation prior to 1965. Rather, the evidence suggests that Indonesia's economic performance is fundamentally due to a substantial improvement in economic policies.

The managers of Indonesia's economic transformation were a small group of mostly U.S.-trained economists -- funded by the Ford Foundation and AID's predecessor, the ICA. These economists had taught at University of Indonesia, and also at the military staff college prior to 1965. In the latter place, they established links with the military officials, including General Suharto.

After inheriting inflation of 600% in 1966, the "technocrats" who managed Indonesian economic policy moved quickly to lower fiscal deficits and to restore international payments. On the fiscal side, the GOI adopted and maintained the principle of no domestic financing of government deficit spending. This "no deficit" policy has eliminated what is typically the major source of inflationary finance in many developing countries. Inflation was quickly brought down from the hyperinflation of 1965, and has been held below 10% in most years since the early 1980s. The second principle of macroeconomic policy has been convertibility of the rupiah, in effect since 1971. Convertibility has forced the Indonesian central bank to maintain private-sector confidence in its monetary management. Any loss of confidence would quickly lead to a run on the currency. Indonesia has managed this process without ever resorting to an IMF standby agreement through careful management of its economy, by holding foreign exchange reserves in adequate amounts, and by being willing to make immediate adjustments when external shocks occurred.

In addition to balancing the budget and maintaining currency convertibility, the Indonesian policymakers avoided some implicit subsidies common in other countries. Like other oil-exporting countries, the government felt political pressure to keep oil prices below world levels after the run-up in prices in 1973. While doing this initially through price controls, the GOI subsequently placed the subsidy on-budget so that the cost of the subsidy had to be taken into account in the budget process. This created pressures to raise domestic oil prices in order to make budgetary room available for high-priority spending programs. By 1993, oil prices had been raised approximately to world levels. Indonesia seems to be the only major oil exporter that has achieved this, and the explicit budgeting of the subsidy is the explanation why.

Indonesian investment policy was also an important factor in economic growth. In addition to a considerable emphasis on education and health investment in rural areas, government policy from early in the Suharto period had promoted investment in rural infrastructure. This was at least partly as an employment-generating activity. The Government established "Inpres" (for Instructions of the President) funds for labor-intensive rural projects. Some of these activities were funded from U.S. PL-480 local currency generations. The rural investments provided tangible benefits to rural areas that helped assure broad-based growth. Intensive government efforts to stimulate rice production through dissemination of "green revolution" technology (also areas where USAID played a significant role), also contributed to rural prosperity.

The three major elements of the policy set -- balanced budget, an open capital account, and rural investment -- do seem to have provided a sound economic policy context. Nevertheless, it should be recognized that the elements did not, and still do not, constitute orthodoxy in this matter. Indonesia adopted its balanced-budget policy at a time when economists in the United States were chiding politicians to abandon their preoccupation with annual balancing of government budgets. Once freed from this fetter, the politicians have never looked back, and balanced budgets quickly went from the norm for U.S. budgets to an almost long term goal requiring a gargantuan effort. Freeing the capital account was unorthodox in 1971, because of the potential for massive outflows of capital in any crisis. Economists believed that trade in goods should be liberalized first, and that capital flows should be freed later, if at all. Finally, the emphasis on rural investment was contrary to orthodox development policy in the 1960s, which emphasized taxation of the rural "surplus" in order to finance urban industrialization. The solution to the paradox -- that the individual Indonesian policies were heterodox while the overall policy is claimed to be orthodox -- lies in its political economy. The first two elements of the triad were more valuable for their power in preventing large errors than in their intrinsic importance. They narrowed the range for policy decisions in ways that forced choices to be made. The third element of the triad helped prevent the political calamity that has befallen some countries where growth was too concentrated in the urban sector, besides producing unexpected economic returns to investment in rural areas and rural people.

4.4 *External Shocks, Stabilization, and Deregulation After the Oil Boom*

The boom in oil prices spurred Indonesian economic growth during the 1970s, and it was heavily dependent on oil for both export earnings and government revenue. Nevertheless, it is Indonesia's performance once oil prices began to decline that is most impressive. The World Bank has noted that "Indonesia's performance is by far the best of the major oil exporters since 1985"⁴. The lower price for oil since 1985 has cost Indonesia annually revenue equal to 18% of its 1986 GDP. Despite this shock, GNP growth since 1985 has averaged more than 6% per year, while inflation has been held to an average of 8%.

Indonesia's success in the face of the adverse developments seems due to two major factors. First, unlike most of the oil exporters, Indonesia drastically cut government spending to match the decline in oil revenues. These cuts fell most heavily on the investment budget, but big budget cuts proved less harmful than the policy of most oil exporters of maintaining spending while the fiscal deficit grew. Second, the government began to be increasingly concerned with sectoral and efficiency issues. Indonesia's capacity to compete in world markets with non-oil products was described by technocrats as impaired by the "high-cost economy". A wide range of sectoral impediments were seen as responsible, and monopolies resulting from heavy restrictions on international trade reinforced such impediments. This analysis led the Indonesian policymakers to embark on a series of liberalization episodes during the past decade. These efforts were aimed at creating export competitiveness for the industrial sector. Table 4.1 summarizes the major actions.

The drive toward a more efficient economy involved economists in a wider range of smaller policy issues. With the increasing complexity of the Indonesian economy, it was perhaps no longer possible for a few skilled technocrats to manage the economy adequately from the top. The increasingly broad and sophisticated industrial sector responded quickly to government policy actions, and the potential for distortions grew with the complexity of the economy.

⁴World Bank (1994) p. 16

Table 4 1

Liberalization Episodes since DSP Began

1 Foreign Investment Policy Liberalization of Regulations in

April 1985

May 1986

1988

April 1992

2 Trade Liberalization cuts in tariffs in

May 1986

October 1986

January 1987

December 1987

November 1988

May 1990

June 1991

June 1993*

October 1993*

3 Customs Service privatized, April 1985

4 Bank regulatory reforms

Credit Allocation and interest rate ceilings ended, 1983

Opened to new banks, foreign and domestic, 1988

5 Transportation regulatory reforms in 1985 and 1988

6 Tourism policy reform in December 1987

7 Insurance Reform in October 1988

Except for starred items, liberalization episodes are from Hill (1994) Starred items are from MacIntyre, 1994

4 5 *The Role of BAPPENAS*

The Indonesian National Planning Agency, BAPPENAS, has played a key role in Indonesian economic policy, and much larger than the role typically played by the national planning office in developing countries. It has played a major role in interagency debates on economic policy issues. Until recently, BAPPENAS was the secretariat for the monetary board, being seen as the honest broker between the ministry of finance and the central bank. The major figures among the economic technocrats have headed this office prior to moving to head the other two economic policy players, the central bank and the ministry of finance, or to become the Coordinating Minister for Economic Affairs. The current Coordinating Minister was head of BAPPENAS in the previous term of government. BAPPENAS has two specific major responsibilities: preparation of the national 5-year plan, or REPELITA, and of the annual government investment budget.

REPELITA. BAPPENAS prepares the five-year development plans of the GOI, for which the sixth was introduced in 1993. The plans provide broad outlines for government policy during a presidential term. The current plan emphasizes poverty reduction, particularly through increased attention to Eastern Indonesia.

The Development Budget. BAPPENAS also decides on the allocation and amount of the government's annual investment budget, exceeding \$13 billion per year, or about 8% of GNP. This places the institution at the center of the decisionmaking process on program directions. Economic policymaking in Indonesia, both on the specifics of the development budget and on other policy issues is usually characterized as very collaborative, with consensus playing an important role, and with extensive use of interagency working groups to identify and elaborate new policy initiatives.

4 6 *Role of the USAID Mission and EPSO*

In financial terms, USAID is a small donor in Indonesia. Its \$60 million per year in gross flows, represents less than 3% of net ODA, and less than 1% of total official flows. On a net basis, U.S. ODA was less than marginal in 1992 and 1993, as Indonesian repayments on past U.S. aid exceeded new funding. This compares with more than \$1 billion per year in net ODA from Japan and more than \$500 million from the European Union and its members. The World Bank and Asian Development Bank each provide more than \$1 billion per year in new lending. It is clear that the USAID has influence in Indonesia far beyond the meager resources it provides to Indonesia⁵.

⁵The evaluation team's access to senior officials of Bappenas, the Ministry of Finance and the central bank in doing the evaluation is evidence on this point. The willingness of such officials to discuss at length Indonesian economic policymaking and the DSP project is itself evidence both of disproportionate USAID access and of a high valuation of the project by the Indonesian government.

The marginal role of AID is also illustrated by Table 3 1, which shows the relative USAID position in grant technical assistance According to the estimates compiled by UNDP for 1993, AID provided about 5% of the grant-funded foreign experts to Indonesia Its contribution again was dwarfed by that of Japan Nevertheless, AID provided a substantial share of total foreign technical assistance in three areas economic management, development administration and health

Table 3 1

**Foreign Advisors in Indonesia
Funded by Donor Grants**

<u>Sector</u>	<u>USAID</u>	<u>UNDP</u>	<u>Japan</u>	<u>Other</u>	<u>Total</u>	
Economic Management	15	5	0	0	20	
Development Administration		5	6	0	8	19
Natural Resources	0	12	175	35	222	
Human Resources	0	23	39	99	161	
Agriculture	19	23	120	207	369	
Industry	0	45	0	40	85	
Energy,Transport, Communication	4	32	186	30	252	
International Trade	0	0	3	3	6	
Social Development	4	44	14	18	80	
Health		19	15	0	6	40
Other	<u>5</u>	<u>23</u>	<u>30</u>	<u>30</u>	<u>88</u>	
Total	71	231	564	476	1,342	
Share	5%	17%	42%	36%	100%	

Source UNDP, Development Cooperation Indonesia, 1994

In the first two categories, USAID is the dominant provider (A UNDP project with the Indonesian foreign investment promotion agency is the only other donor activity in these areas) The USAID activities included the DSP project and two sub-projects under its AARSP project -- one to assist the ministry of trade on trade policy issues and one to provide tax experts to the ministry of finance and specialized financial experts for the central bank The USAID involvement in these areas is particularly noteworthy in view of the Indonesian government's reluctance to have foreign involvement in economic policy issues (Indonesian policy rejects conditional foreign assistance, and Indonesia has not had an IMF stand-by for the last two decades) Consequently, the willingness of the GOI to accept USAID assistance in this area is an indication of confidence that U S technical assistance genuinely serves Indonesian needs, rather than some purposes of the donor A number of Indonesian government officials interviewed indicated that AID has a comparative advantage over other donors in this type of assistance

Although the DSP team saw its mandate as serving BAPPENAS' needs, the project appears also to provide some benefits to the AID mission. First, operational and management issues from the project put USAID staff, particularly the economists in the EPSO office, in frequent contact with senior BAPPENAS staff. This creates opportunities for dialogue on economic issues. Second, the technical discussions among economists at DSP, in BAPPENAS and in EPSO appears to have benefited all three parties in interpreting Indonesian reality.

More broadly, the involvement with BAPPENAS simply puts USAID into a position of being able to understand and appreciate the economic policy issues facing the Indonesian government. This has been helpful to the mission in designing its assistance strategy, and in providing useful perspectives in other fora, such as the World Bank-led Consultative Group on Indonesia. It also provided entree for the mission with the central policy formation process on technical issues in sectors such as health and environment, where USAID's work is primarily with line ministries or with NGO's. This ability to address concerns at the policy level should increase the effectiveness of such sectoral projects.

Chapter 5 Assessment of DSP II Policy and Institutional Impacts

5.1 Overview of DSP II Research and Consulting Program

DSP II began its work with BAPPENAS in 1987 by proposing a research program focused on employment, industry and trade policies. "The central purpose of the research program under DSP II is to strengthen the factual and analytical base for policy decisions in dealing with the issues of employment, industry and trade. In its first year the program was also concerned with providing results useful in the formulation of REPELITA V. Finally, in its first year and a half, the program worked to strengthen systems for gathering and using statistical data."⁶ With a clear focus on policy relevant research, DSP II activities were organized into three special-purpose and one general-purpose blocks that focused on the impacts of government policies. These were

- **industrial structure**, including issues such as public vs private ownership, foreign and domestic investment, technology transfer, and small vs large enterprises,
- **impact of government policies on product markets**, including trade and industrial structure issues
- **governmental policies affecting input markets**, especially labor markets, and
- **data systems and analytical methods and models**, which was seen as providing the infrastructure for other more directly policy-relevant research

While the program was initially intended to build data, informational and analytical bases for medium-term policy use, the program that was in fact implemented was potentially relevant to the government's ongoing program of deregulation, decentralization and debureaucratization. However, the voluminous outpouring of research during the first two years of DSP II was not significantly utilized by BAPPENAS policy makers. Some of the research was circulated to the wider economic policy research community, but its policy impact was apparently minimal.

As the DSP II program evolved, the focus shifted from a think tank with supply-driven menu of research designed by DSP consultants to a demand-driven model that reflected more specific policy needs of BAPPENAS decision makers. This shift included increased emphasis on budgetary issues, macroeconomic policies and projections, health, education and poverty issues, regional development concerns, and assessments of investment proposals of other government ministries and donors. The program shifted from a research program to a more interactive policy advisory relationship that continued to

⁶ "DSP II Research Program Employment, Trade and Industry, Planning Document #1," October 1987

support the objective of increasing the efficiency of governmental policies and programs affecting employment, trade and industry. The consultancy relationship that evolved provided a multitude of useful but confidential technical analyses and advisory services in support of BAPPENAS management and policy makers. As a result, the production by DSP advisors became increasingly difficult to document. However, policymakers inside and outside BAPPENAS repeatedly attested to the evaluation team that this approach increased the usefulness of DSP II to BAPPENAS decision-makers.

The research and advisory services provided BAPPENAS by DSP II affected the policy reform environment within BAPPENAS and other ministries largely by providing evidence of the efficacy of reform actions already initiated. As with all comprehensive reform programs, there was real need to demonstrate that the reforms were in fact producing broad-based benefits. DSP also played a significant role in defending against policy retrogression through its advisory role in assessing development project proposals. While DSP II can not be credited with directly initiating new reforms, it clearly supported BAPPENAS' capacity to participate in inter-ministerial reviews of policy reforms and budgetary and development program decisions supportive of reform.

A sampling of DSP II work and impacts on policy reform and maintenance is presented in the following section. This section is followed by an overall economic assessment of DSP's role providing technical assistance and analyses to promote and maintain reforms and prevent policy deterioration.

5.2 Examples of DSP II Policy and Institutional Impacts

5.2.1 The Bali Boom and Foreign Investment Deregulation

In 1987 DSP initiated a series of studies on the role of foreign investment and firm size in transferring technology and expanding exports. The first study, "Is Small Foreign Enterprise Beautiful," argued the theoretical case for encouraging foreign investment in many small enterprises. It argued that such firms provide on-the-job training and easily replicable models of technology and management. This model was contrasted with the nationalistic preference for a limited number of large foreign investments which could be readily monitored by the authorities, but which offered limited potential for technology transfer, management emulation and export growth.

The theoretical analysis was complemented by an empirical assessment of "The Boom on Bali: Implications for Research and Policy." This paper documents a boom in non-traditional exports from Bali that was only beginning to be noted. This export growth, notably in garments, was dominated by small-scale rural enterprises under indigenous ownership and management. Country roads were lined with households producing for export on a putting-out basis, and rural incomes were moving up fast. Product lines were diversifying rapidly, as local enterprises proved themselves capable of competing in high-

value markets where short product cycles, demanding quality control, and tight delivery schedules are the norm. Small foreign investors serving mainly as consulting designers and marketers were the essential links between local firms and external technology and marketing channels.

Bali's export boom would probably never have materialized without major governmental investments in communications, transportation, and other infrastructure for the promotion of foreign tourism. However, the paper argued, enforcement of existing laws governing foreign residence, investment and business ownership would also have prevented the boom from occurring. Balinese export manufacturing took off because these laws were not enforced. Foreigners who had entered as tourists sometimes remained and began exporting garments on a small scale. The success of the initial exporters stimulated imitators, and led to rapid increases in production for export. As linkages with foreign buyers were stimulated, new designs and adaptations to foreign tastes further increased the export potential.

The paper argues persuasively that Indonesia's laws are biased against foreign involvement in small enterprises and that reform is essential to export growth. The paper calls for (1) relaxation of the extremely strict immigration laws which discourage foreign entrepreneurs and professionals from coming to Indonesia, (2) liberalization of laws governing foreign investment and ownership, (3) deregulation of air transportation and the upgrading of airports and seaports.

DSP's 1988 study "Made in Bali: An Indonesian Export Success Story" documents in more detail the Bali garment export boom and the role of foreign buyer-consultants in introducing higher value designs and penetrating fashion markets in the U.S. and Europe. In 1993 a final DSP study on Bali, "Follow up to the Boom in Bali: Preliminary Assessment," documents that the boom on Bali continues, but it faces heightened competition from China and elsewhere in the production of low-skill goods. The opportunity to capitalize on the emergence of Bali as a design center and source of competitive advantage for all of Indonesia is seen as a way to overcome the competitive challenge. Policy recommendations again focus on liberalization of immigration and investment rules.

While the first two studies were widely distributed throughout the policy research community in Indonesia, restrictions on distribution of the latter two reports limited their readership to BAPPENAS policy makers. However, BAPPENAS staff said they were very useful in inter-ministerial policy discussions, by providing additional evidence of the importance of deregulation, particularly for foreign investment. While no one-to-one relationship is claimed, the studies contributed to inter-ministerial deliberations of proposals for investment deregulation.

Significant reform of the foreign investment regime was in fact initiated in 1989. Of most relevance to small foreign investors, the minimum size of foreign investment was

reduced from \$1 million to \$250,000. The minimum was finally eliminated in 1994. Other reforms adopted in 1989 included the relaxation of divestiture requirements (eliminated for export activities), replacement of a restrictive positive list of sectors eligible for foreign investment with a short negative list of sectors where foreign investment is prohibited, and foreign firms were given almost the same access to domestic financing as domestic firms. Investment deregulation was accompanied by deregulation of shipping. Finally, free entry of tourists without the need for visas, which had operated only for Bali, was extended to other parts of Indonesia.

While it is not possible to separate out the independent effect of foreign direct investment reforms from the broader reform program, including trade and financial sector liberalization, the investment reforms clearly were significant contributors to the foreign investment boom that has taken place since. Approved foreign investment increased from an average of around \$2 billion a year between 1984-1988 to an average of over \$8 billion a year between 1989-1993. Of more relevance to the small scale investment recommended by the DSP studies, foreign investment in textiles and leather increased from an annual average of around \$70 million between 1984-88 to an average of over \$600 million per year between 1989-93.

5.2.2 BPS Data Improvement, Institution Building, and Data Uses

It was recognized at the beginning of DSP II that national data deficiencies significantly limited the opportunities for empirical policy analyses and sound policy formation in Indonesia. The Central Bureau of Statistics (BPS) is a very professional organization, and collects and publishes in a timely fashion an unusually wide range of data compared to other countries in a similar stage of development. Nevertheless, reliability of some of the data was questionable, and difficulties in accessing and using interrelated data sets were seen as an impediment to policy analysis.

Much of the success of the DSP II collaboration with BPS is related to its support of institution-building. The DSP consultants developed and installed various statistical systems to assure increased reliability and comparability. They also worked directly with the staff and trained them in updating and managing these systems. This training emphasized more systematic methods to analyze data problems. The consultants also taught staff members how to communicate more effectively through written reports.

The initial assignment given to the DSP consultants was to create a new directory system for industrial, trade and employment data. A new system was designed to decrease under-coverage and to identify inconsistencies in survey data. A major part of establishing these data bases was resolving inconsistencies between surveys. These exercises eventually led to the backcasting system (discussed below). In addition to the creation of these systems, eleven statistical papers incorporating this data were written.

DSP II consultants also designed a process of updating historical information on

medium and large establishments called backcasting. Indonesia has an annual census of such establishments. New firms often had operated for some years before entering the statistical net, and any employees and sales of such firms were attributed to the year they were first identified. This method involved re-surveying newly-identified establishments for historic data on employees and date founded, and using this information to adjust the survey data for previous years. Eighteen statistical papers and research memos were written on backcasting.

Use of the backcasting system led to major revisions of manufacturing value added and the GDP growth rate between 1981 and 1987. Prior to these revisions, the GOI had estimated the growth rate of manufacturing at 6 percent, and the growth rate of GDP at 4.1 percent per annum. Following the DSP analysis, manufacturing growth was revised to 13 percent and annual GDP growth was raised to 5.1 percent. These revisions were of great importance for subsequent GOI policy discussions. In response to oil price declines, the Indonesian government had begun a series of reforms beginning in 1983 toward a more outward-oriented policy framework. The initial reading of the national income data showed practically no response in manufacturing output nor in GDP to these initial steps. As a consequence -- and because some firms had been hurt by increased competition -- the deregulation policy was increasingly being questioned.

These new results greatly strengthened the hand of the technocrats in arguing for maintaining and intensifying the freeing of the economy. The new manufacturing data also demonstrated that deregulation had not been detrimental to small firms, as was previously thought. The higher growth rate further explained why energy infrastructure had not been able to keep up with demand in the 1980s. Once it was clear that manufacturing had been increasing at twice the rate originally thought, the energy deficiency was easily explained. The revised data, by establishing a more correct linkage between growth in demand for energy and growth in manufacturing and GDP, led to downward revisions projections for needed energy infrastructure in the 1990s. Better data prevented overinvestment in electric generating capacity.

Significant progress in surveying techniques and cleaning data was made in the quarterly and annual surveys of large and medium manufacturing establishments. Improvement of the surveys has required changes in sampling procedures, questionnaire design, and computation procedures. DSP installed a computerized system to handle these surveys and produce the latest quarterly manufacturing growth rates. These surveys are now the source of manufacturing GDP data for Indonesia. In addition, twelve written reports on the survey system were produced.

DSP consultants also worked on SAKERNAS, a quarterly labor force survey of 65,400 households, and the annual SUSSENAS survey which provides information on socioeconomic indicators such as income, education, and health. These two projects were not fully completed due to time constraints and lack of future funding for DSP. DSP also piloted a management information system which collected information from the Kabupaten,

or sub-regional, level

Indonesian assessments of the BPS data systems work were highly positive. BPS senior management strongly praised the DSP consultants, and indicated that they would have liked to see the project continued. They were more than satisfied with the directory systems and backcasting methods and felt that these systems could be managed in the future without assistance from DSP. However, they indicated that continued assistance with the quarterly surveys, SUSSENAS, and the management information system was needed. The technology/knowledge transfer from the DSP statisticians to BPS staff members stood out as one of the collaboration's most important features. BAPPENAS and BPS were clearly pleased with the close working relationships that had developed, with BAPPENAS being one of the heaviest users of BPS data. The links between BAPPENAS and BPS as users and suppliers of statistics were also strengthened by the project, to the benefit of both.

Other policy analysis units in Indonesia, including HIID and the World Bank, argued that the data improvement assistance provided by DSP II has been extremely important to all concerned with reliable data for policy analyses. While no one knew how to quantify the value of such data improvements, all agreed that DSP's effort were extremely valuable to sound policy analyses.

Significant praise for statistical upgrading has recently come from the press. A Jakarta Post (March 29, 1995) editorial commended the Central Bureau of Statistics (and indirectly DSP) for "the efforts by the bureau to steadily improve the reliability and relevance of its statistics. As foreigners pour billions of dollars into the emerging market countries like Indonesia, the availability of more up to date, reliable economic data has become one of the factors considered in picking the place of investment. Economic statistics which are timely, accurate, comprehensive and objective are crucial for investors wanting to analyze business prospects and risks."

5.2.3 DSP Modeling for the Budget, REPELITA and Development Policy

A considerable portion of DSP resources (perhaps as much as one-fourth) have been devoted to work with models of the Indonesian economy to analyze micro and macro policy issues and provide regional and national projections for annual budgets and the national 5-year plan, REPELITA. DSP's first modeling paper in 1987⁷ surveyed the existing Indonesian models, including Input/Output (I/O), Social Accounting Matrix (SAM) and Computable General Equilibrium (CGE) models. With several I/O models already in place in the Ministry of Industry and BAPPENAS, it was concluded by DSP that what was most needed was a set of relatively small, US-style CGE models which could be run in Indonesia. DSP agreed to work cooperatively with the Harvard Institute for International Development (HIID) group at the Ministry of Finance on developing the models, with HIID

⁷ DSP, "Economy-Wide Macroeconomic Modeling in Indonesia," 1987

to focus on interest rates and the balance of payments, while DSP models were to focus on employment generation, regulation and income distribution. A series of papers followed in 1988⁸ documenting DSP's considerable efforts to develop and utilize operational CGE models to capture the direct and indirect economy-wide effects of policy changes, such as devaluation, deregulation, export promotion, and physical and human capital investment policies. As the difficulties with fully implementing such complex models, including data shortfalls, became apparent, DSP's interest in CGE modeling ended, and BAPPENAS pressed for simpler modeling that would directly support planning for REPELITA and annual budgets. In retrospect, it seems clear that the CGE modeling effort was overly ambitious.

In mid-1989 DSP initiated its Macro Modeling Project in collaboration with BAPPENAS⁹. The Deputy for Monetary and Fiscal Affairs requested DSP II to work with members of a 15-person Working Group as they constructed a short-run macroeconomic model of the Indonesian economy. The model was geared to the annual budget cycle, and was to be used to estimate the impact of policy changes on economic indicators such as national production, investment, employment and inflation. DSP II staff provided critical technical assistance for determining the structure of the model, obtaining needed data, and setting up appropriate computer software to perform simulations using the model. The macroeconomic modeling effort became a major forum for data transfer, with BAPPENAS economists building their own data bases using DSP II re-estimates in areas such as industrial data (backcasting), price deflators, capital stock, and input-output tables.

In 1990 the BAPPENAS macro-modeling team began to use the model developed with DSP for annual budgeting. However, the model proved difficult to use and interpret quickly and BAPPENAS decided that a more simplified model structure was required. In early 1991 a series of meetings were held on modeling direction. A number of alternatives, including a short-run econometric model, a computable general equilibrium model, various aggregate econometric models and the planning model used by the World Bank were reviewed. It was decided to build upon the World Bank model known as the Revised Minimum Standard Model (RMSM)¹⁰.

The RMSM model was extensively modified, incorporating previous econometric work, adding Indonesia-specific elements like an oil sector, and building a much enlarged government account. The model was implemented in Quattro Pro. Responsibility for the

⁸ DSP, "Multi-Sector Economy-Wide Models: An Update and Future Research," February 1988, "The Impact of Commodity Price Instability: Experiments with a General Equilibrium Model for Indonesia," June 1988, "Trade Deregulation in Indonesia: A General Equilibrium Analysis," August 1988, "DSP CGE Modeling System: Data-Base and Computer Programs," August 1988.

⁹ DSP, "DSP REPORT: QUARTERS 8 AND 9 and ANNUAL REPORT #2," September 1989.

¹⁰ DSP, "Final Report: Macro Model RP #3: BAPPENAS Planning Model, Phase I," December 1993, "BAPPENAS Planning Model: Documentation and Description," December 1993, and "Final Report, Macro Model RP #3,10: BAPPENAS Planning Model Phase II," April 1994.

model was divided among various Bureaus within BAPPENAS. The Macro Planning Bureau became responsible for the main model, overall coordination, and supply side growth projections, demographic, labor force and employment trends, and price determination. The Monetary and Fiscal Bureau took responsibility for the budget block, the monetary block, the oil and gas block, and flow of funds analysis. The Balance of Payments Bureau and the Economic Analysis Bureau have worked together on the external sector. The Balance of Payments Bureau is responsible for the current account, while the Economic Analysis Bureau is responsible for the capital account. Thus each group is separately responsible for different blocks of the model, which then must be combined to interact with other parts of the model.

DSP's extensive work with BAPPENAS staff in developing the model is widely seen within and outside BAPPENAS as having provided a major transfer of technical skills. The BAPPENAS staff is now capable of independently running, maintaining and upgrading the model. The model plays an essential role supporting BAPPENAS' main task of guiding the development and implementation of the development budget. The model has been utilized by BAPPENAS since 1991 to develop annual development budgets. It is also utilized by BAPPENAS to develop the macroeconomic projections in the 5-year plan (REPELITA) and the 25-year plan. The 5-year REPELITA economic projections are used as guides in the development of the annual budgets, including priority development activities. The BAPPENAS model has facilitated containing government expenditures to levels that are consistent with oil revenue and non-oil exports, and international debt, domestic growth and price stability objectives. The model also allows BAPPENAS policy makers to explicitly analyze the impact of various development scenarios, and to set realistic growth targets and the policy requirements for their implementation. Assessment of regional development issues for REPELITA are facilitated by using the macro model projections as controls for regional and sectoral projections using input/output models developed with DSP support.¹¹ Given the wide disparities of per capita income and the concentrations of poverty on the Eastern Islands, interregional modeling is considered an important addition to BAPPENAS' modeling capacity.

While the budget and the overall development program articulated by REPELITA are the product of intense inter-ministerial negotiations, the model has clearly enhanced the ability of BAPPENAS senior staff to contribute to major budgetary and development policy discussions and decisions on a more equal footing with other ministries which also have modeling capacity, including the Ministry of Finance and Central Bank. The modeling competition among ministries has enhanced the quality of macroeconomic analyses, and the quality of economic decision-making, thereby improving the economic performance of the country.

¹¹ DSP, "Regional Economic Development Planning in Indonesia: An Integrated Modeling Approach for REPELITA VI and PJP II," Research Memos #90-#93, August 1993.

The BAPPENAS modeling effort should be seen as a major DSP contribution to sound policy in Indonesia. Given the size of the government development budget (approximately \$13 billion) and the importance of sound quantitative assessments of macroeconomic performance, improved BAPPENAS modeling appears to have been a valuable investment. In retrospect, the costs of developing the final version of the model would have been lower had the modelers taken an incremental approach (starting with a very simple model and adding complexity as its need became evident) rather than an academic approach (building a complex model, and having to reduce its size and complexity because of the inability to maintain it or use it for day-to-day analysis).

5.2.4 Rural Credit Reform

The efficacy of various rural credit and savings programs for poverty alleviation was the focus of a policy-oriented research effort in 1990 under the direction of BAPPENAS's Deputy for Fiscal and Monetary Policy and the Deputy for Social and Cultural Affairs. The research was conducted by a joint BAPPENAS and DSP Task Force.¹² The task force's work plan included background research on rural financial institutions, extensive interviews in Jakarta with financial institutions, governmental agencies and other organizations involved in poverty lending, field visits and detailed evaluations of existing Indonesian rural financial institutions, and field interviews with the poor in rural areas. A series of presentations throughout the year kept BAPPENAS senior staff abreast of the Task Force's findings.

The programs chosen for detailed study included a variety of banking programs operating in rural areas, a revolving credit fund operated through the Department of Education, and programs of the Department of Agriculture and the National Family Planning Organization. These in-depth reviews of credit programs provided empirical evidence in support of various group lending approaches and encouraged BAPPENAS to support this approach in its review and approval of development project proposals. The expansion of such programs since that time has made Indonesia the world leader in microfinance lending in the developing world, with more than 2.5 million borrowers from sustainable microfinance institutions.¹³ BAPPENAS also incorporated elements of the group lending approach in the INPRES program for the poor that was developed under REPELITA VI (see below).

The assessment of the Department of Education credit program, which was being considered at the time for a World Bank project renewal, provided constructive recommendations for program revisions. As a result, the project was modified, including

¹² DSP, "Rural Credit, Financial Institutions and Poverty Alleviation," Research Papers #8 and #9, October 1990.

¹³See Christen, et al., 1995.

the curtailment of an ineffective building construction component BAPPENAS' favorable experience with this evaluation experience has led to adoption of this approach in subsequent development program evaluations by BAPPENAS

5 2 5 INPRES Consulting Improves Targeting the Poor

The annual development budget includes approximately \$3 billion of INPRES grants to provincial and local governments These budgetary transfers have traditionally been used to finance local government capital improvements, including schools, health centers, roads, and water supply and irrigation infrastructure Beginning under REPELITA VI in 1994, special INPRES funds have been dedicated to poor communities The new system provides approximately \$10,000 for each poor community (typically 30 households) to be used in a revolving credit fund managed by the community As noted earlier, this was influenced by the earlier BAPPENAS research on rural credit and group lending

While the INPRES program has provided significant resources to upgrade local infrastructure (especially rural schools) and increased employment opportunities for the rural poor, a number of problem areas were apparent The INPRES poverty grants have not effectively targeted poor communities, with many leakages to non-poor communities Construction standards were found to be often below agreed to standards And local community financial self-reliance was being undermined by INPRES

To address these problems, the BAPPENAS Deputy V organized a task force of ten BAPPENAS staff supported by technical assistance from DSP and USAID's Municipal Finance Project Task force recommendations included (1) Some \$200 million of development project funds should be shifted to INPRES grants for local governments, (2) block grants should replace fully-specified grants, to encourage local control, and local project construction standards should replace uniform (and excessive) national standards, (3) INPRES should stimulate local self-help by matching funds when local revenues increased by more than 15 percent, and (4) the administration of INPRES should be streamlined and made more transparent

While these reforms are still under consideration, it is apparent that the potential impacts on the rural poor and local government development are likely to be significant DSP and USAID's Municipal Finance Project have enhanced the level of understanding of the technical issues and the prospects for constructive reforms

5 3 *Economic Assessment of DSP Policy Impact*

From the foregoing review of a few examples of DSP research and consulting services within BAPPENAS, it should be clear that DSP significantly contributed to policy debate and decision-making within BAPPENAS, especially after the project evolved to a demand-driven model of confidential policy advisory services These interactions enhanced BAPPENAS decision makers' ability to improve GOI policy in a variety of ways These

included reviews of specific policy issues, development of REPELITA, annual budget negotiations, and investment project reviews

Despite the contribution of individual DSP II initiatives, the evaluation team does not judge it to be feasible to quantify the value of individual DSP initiatives. In any significant policy decision by government, there are many factors and actors that play roles leading to the final decision and to the manner of its implementation. Consequently, one cannot unambiguously state that any important policy action was the result of DSP II. Given the quality of DSP advice, the evidence suggests that decisions were better than they would otherwise have been, because DSP II advisors provided facts and clarified issues for the decisionmakers. Despite this difficulty, it may be possible to plausibly estimate the overall impact of DSP II on the government's policy reform program.

The World Bank's recent analysis of the impact of the deregulation reforms provides a useful starting point for assessing the overall policy impact of DSP II (World Bank 1994, pp 24-28). The series of deregulation packages that began in 1985, along with the rapid accumulation of physical and human capital, have been the keys to Indonesia's rapid growth of income and employment and poverty alleviation, in the face of the massive decline in petroleum export revenues. The deregulation reforms increased external and internal competition by reducing protection, investment licensing and discrimination against foreign investors. Prudent macroeconomic management, including budgetary and exchange management, were necessary complements to the reform program. Poverty alleviation was enhanced by labor-intensive industrial expansion and government investments in health and education.

The World Bank's analysis concludes that the deregulation program improved the efficiency of resource allocation and the productivity of capital and labor inputs. The trend in "total factor productivity" is an indication of changes in such efficiency. Total factor productivity increases when output rises by more than what can be accounted for by increased inputs. The data for the 1979-85 pre-reform period show no increase in total factor productivity: all growth in output can be explained by increased inputs. Since 1985, however, GDP has grown by about 1.2 percent per year faster than can be explained by labor, capital and human capital accumulation. This 1.2 percent represents increased efficiency associated with the deregulation of the economy. (In addition, the World Bank suggested that deregulation also was associated with higher rates of capital accumulation, which further contributed to faster growth and poverty alleviation.)

The economic policy-makers within the Government of Indonesia were responsible for the adoption, implementation and maintenance of the deregulation measures that began in 1985. While assigning responsibilities within the Government is difficult, it is clear that BAPPENAS has played a significant role through its control over the \$13 billion development budget and REPELITA and its involvement as a major player in inter-ministerial policy dialogue and decision making. Economic policy advisors provided by the donor community and their analyses enhanced the effectiveness of Indonesian policy.

makers and economists who inspired, initiated and took responsibility for implementing the many difficult reforms. While a quantitative estimate of the contribution of externally-provided economic analysis and advice is clearly matter for speculation, a minimum share of 10 percent is considered to be a reasonable estimate by the evaluation team. In other words, the decisions made by Indonesian policymakers were 10 percent more socially productive than they would have been without the ability to draw upon any external advisors. There is wide agreement that the World Bank's extensive analytical work in support the reform program over the past decade provided a large contribution. In addition, a significant portion should also be allocated to HIID, which has provided technical support for reforms initiated by the Ministry of Finance, the Central Bank and the Coordinating Ministry for Economy, Finance and Development Supervision for most of the last 30 years. Academic literature, particularly the *Bulletin of Indonesian Economic Studies*, probably also made a contribution. Other external centers of influence, including the Asia Development Bank, bilateral donors and USAID should also be credited with significant impact on reform. Within this latter category, USAID's DSP has fielded the largest and most influential policy advisory team. The quality of this team, its close relationship with senior policy makers within BAPPENAS unencumbered by donor-imposed conditionality, and its extensive work supporting policy reform, implementation and maintenance since 1987 should accordingly be allocated at least one percent of the share of policy induced accelerated growth, or ten percent of the share of the external community.

Crediting DSP II with only one percent of the policy reform induced growth, even assuming a lag of approximately two years (i.e., from 1990 on) produces very significant benefits. The policy-induced growth is assumed to be the 1.2 percent real GDP growth after 1985 that was not explained by factor inputs. With a real 1990 GDP of \$111 billion (in 1992 dollars), a one percent share of the 1.2 percent growth generates some \$13 million in benefits in 1990 and each year thereafter with continued maintenance of the reforms (see Appendix 3). To this stream of 1990 growth benefits should be added the additional growth increments that accrue each year thereafter with continued policy implementation. The total flow of benefits in the form of increased national income becomes larger each year until the project ends in mid-1995 (from \$13 million in 1990 to \$94 million in 1995). Assuming that the policy reform program decays thereafter at the rate of 25 percent a year, the benefit stream continues to 2000. The present value of DSP benefits in 1992 dollars is \$492 million, while the present value of DSP II project costs is only \$21 million. Hence, the economic returns to the project have been extremely high, with a net present value of \$471 million.

Needless to say, this analysis rests primarily on the assumed rate of attribution of one percent for DSP II. While this is judged to be a minimal plausible rate of attribution by the evaluation team, the project generates very high returns (NPV of \$28 million) even if the rate of attribution is reduced to 1/10th of one percent. It also should be noted that this only includes the policy reform induced benefits of DSP II. Benefits associated with on-the-job training of Indonesian economists and policy makers and institutional development within BAPPENAS and BPS are additional benefits not captured. Also,

improvements in the income distribution and reductions in poverty associated with policy reforms and improved development budgets are additional project benefits not quantified

Chapter 6 Factors Affecting DSP Effectiveness

6.1 Quality of DSP Consultants

The productivity of the DSP technical assistance was unusually high as a result of a number of factors. The high quality of the consultants was a key element. Development Alternatives Incorporated (DAI) and Boston Institute for Developing Economies (BIDE) fielded a team of 6 long-term and some 34 short-term economists who were typically mid-career professors from major U.S. universities and/or consultants with considerable development experience. All DSP staff were carefully selected by BAPPENAS from among candidates proposed by DAI and BIDE. The BAPPENAS and BPS senior staff that helped to manage DSP II typically had Ph.D.s from U.S. universities and have worked with U.S. consultants before, and hence were strong partners in the consultant selection process. Key consultant characteristics that were sought included the ability to work collaboratively and flexibly with senior Indonesian policy makers and previous Indonesian consulting experience. Most of the long-term consultants became fluent in Indonesian. Many of the more successful short-term consultants returned repeatedly to Indonesia and this enhanced their effectiveness.

The strong sense of purpose of the DSP advisors also was important to the project's success. Even though the team initially was sidetracked with their own academic vision of what was really needed, they overflowed with intellectual energy and dedication to producing an analytical base for future policy work. Once the need to reorder their priorities more closely with those of BAPPENAS became clear, they exhibited tremendous flexibility. Their continued willingness to work closely with and for their BAPPENAS counterparts clearly paid off in moving the project to a valued analytical component of BAPPENAS.

The quality of AID-provided experts and the confidence placed in them by host government officials largely explains why they are considered so valuable. Not being associated with externally imposed conditionality and large resource transfers enhanced the ability of the AID advisors to work closely with their counterparts. Advisors linked to large resource flows and conditionality seldom gain the trust and confidence of their counterparts.

6.2 Size of the Advisory Team

Having a core of between 4 and 6 long-term advisors was essential to providing both synergy and linkages to Indonesian counterparts. The long-term advisors built close working relationships with their counterparts and worked hard to integrate the short-termers into the ongoing needs of BAPPENAS and BPS. The size of the team was appropriate. A smaller team would not have had the critical mass to provide needed specialization and division of labor nor complementary professional interactions. A larger team would have

created more intra-team interactions with little additional output. While there were only two advisors at BPS, they benefitted from interactions with the larger team in BAPPENAS.

6.3 Supply vs Demand Driven Advisory Services

DSP II began with a supply-driven model of technical assistance to BAPPENAS. The initial design provided too much technical virtuosity by foreign economists working together and very little benefit to BAPPENAS in meeting its real policy decision making needs. The excessive number of short-termers (25) and the voluminous outpouring of research papers (nearly 90) during the first year-and-a-half was more than could reasonably be expected to be utilized by busy counterparts. Consequently most of the early short-termers seldom saw their counterparts and many of their papers were not read by BAPPENAS policymakers.

After restructuring the project in 1989, the team seems to have met BAPPENAS' needs well. The restructured project shifted to a demand-driven approach, where BAPPENAS senior counterparts directed the project to meet their most pressing needs: dealing with the development budget, reviewing development project proposals, preparing REPELITA, and interacting with other ministries on policy issues. Implementation of a demand-driven model is much harder in practice than in concept, as it requires an interactive process of learning between the advisors and BAPPENAS staff. The BAPPENAS staff need to learn what the advisors can deliver, and the advisors need to learn what BAPPENAS staff need -- and both need to learn to have confidence in the other.

The project evolved in such a way that BAPPENAS developed a strong sense of project ownership. Their sense of ownership has been repeatedly demonstrated by their efforts to ensure that the project continue. In a 1994 meeting with the visiting Deputy Administrator for AID, senior BAPPENAS officials each explained how DSP II was essential to their needs and made pleas for additional funding for the project. While budget shortfalls and other AID priorities precluded continued AID funding, BAPPENAS officials have continued to search for alternative funding, including a possible Asia Development Bank loan.

The advisors that worked within BPS seemed to have avoided the earlier difficulties experienced by the BAPPENAS team largely because the BPS team worked from the beginning trying to meet the needs of BPS.

6.4 Confidentiality and Policy Impacts

The DSP studies were generally of high quality and of relevance to Indonesia policy issues. During the first year of DSP II, the studies were often shared among the larger community of economic researchers in Indonesia. This provided for constructive feedback and dialogue. But as the project moved into a more demand-driven model meeting the

internal needs of BAPPENAS, the sensitive nature of the much of the information necessitated restricting external access. While confidentiality is essential for much internal policy work, it would appear that confidentiality became excessive. For example, even after the economic projections in REPELITA VI had been released to economists outside of the government, access was not provided to the primary source of the projections, BAPPENAS' model. While BAPPENAS officials have to ultimately decide what to make public and what to keep confidential, it would appear that more openness would enhance constructive dialogue with the private sector.

6.5 Institutional Development Efforts

DSP II transferred significant capabilities to BAPPENAS and BPS staffs. The concept of joint project and interagency task forces seemed to have been especially effective. As discussed in the previous chapter, this was the modus operandi for the very successful data systems work in BPS and the macro-model building efforts in BAPPENAS. These efforts and other task forces that involved close interactive work over extended periods provided for meaningful on-the-job-training for a large number of BAPPENAS staff. While some of these counterpart staff had graduate level training in the U.S., the opportunity to work side by side with experienced experts on difficult analytical policy issues significantly enhanced their skills. Other on-the-job-training opportunities were generated by DSP's use of research assistants and to a lesser extent interns. Even though some of the DSP counterparts have moved on to other governmental agencies, the evaluation team repeatedly heard that DSP on-the-job training had significantly enhanced their analytical skills and usefulness to other governmental agencies.

The project also provided considerable institutional development in the form of setting up systems for maintaining the quality of data sets within BPS and the model within BAPPENAS. However, the sustainability of these systems may be in jeopardy once project funding for supplemental overtime and special duty compensation ends. Without a means to compensate for extra work responsibilities, it may prove difficult to maintain the demanding standards developed under the project. The problem of low governmental salaries is clearly an issue that is beyond the scope of the project to resolve. But as the World Bank's study of the rapidly-growing East Asian countries demonstrates¹⁴, adequate civil service compensation is essential for sound governmental institutions.

Institutional development may have also been affected adversely by DSP not being physically located in BAPPENAS. While the team's efficacy as policy advisors was enhanced by their offices' staffing outside of government and the opportunity to work at the office largely free from governmental operational concerns, the lack of having to deal with these institutional problems may have affected their ability to help reform them. Also, the time costs of getting between BAPPENAS and DSP reportedly deterred some staff from

¹⁴World Bank, 1993, pp 175-180

seeking DSP assistance or using the DSP library

6.6 Counterpart Capabilities

The high quality of the BAPPENAS and BPS counterparts stands out as a major contributor to the project's success. Their solid professionalism was in part due to their earlier U.S. training. Many of the counterparts had benefited from graduate economics training in the U.S., and hence were well prepared to utilize the expertise of the DSP economists. A number had Ph.D.s from Boston universities and had studied under professors who later became DSP advisors. Close working relationships were easily reestablished. While some DSP interns, research assistants, and junior counterparts left for graduate education in the U.S. during the project, the most senior counterparts had their U.S. training many years before the project. Long-term graduate economics training clearly has contributed significantly to the success of the project, and to the quality of Indonesian economic policymaking. Such training seems to have been a high-value use of U.S. aid resources.

Strong BAPPENAS and BPS management also significantly enhanced project effectiveness. When the BAPPENAS advisors needed redirection into a more demand-driven model of operation, BAPPENAS provided the needed leadership. This strong leadership style interacting with a flexible DSP team produced a close and productive working relationship. The BPS leadership had very clear objectives for their consultants, and hence their working relationships remained on an even keel throughout DSP's involvement.

6.7 Triangular Communications

Good communication among AID, DSP and the government enhanced the project's productivity. The triangular interaction between the three provided needed support when two-way communications appeared awkward or could be constructively complemented by triangular communications. For example, moving the project from the supply-driven model to the demand-driven model involved discussions and negotiations between AID and DSP, and AID and BAPPENAS. Direct confrontation is generally not the Indonesian style, and so indirect communication through AID has been helpful.

6.8 USAID Management

Related to the triangular interrelationships, it should be noted that the project's continued success required significant management inputs on the part of USAID staff, and most importantly the economists in the Economic Policy Support Office (EPSO). The project would not have survived its early mistakes had the EPSO economists not been on top of the situation and helped to negotiate a constructive solution. Crafting project amendments and gaining support from within USAID for additional financial support required EPSO staff to remain in close contact with the consultants and governmental

counterparts Effectively managing policy advisory projects is demanding and requires strong professional economists within USAID who can interact and gain the confidence of senior counterparts EPSO's considerable efforts have clearly paid off in the case of DSP

USAID's effective project management also produced significant benefits for USAID The EPSO office was able to be in much closer touch with economic policy issues, with improved access to policy discussions and policy makers within BAPPENAS This clearly enhanced EPSO contributions to mission program development efforts Other mission offices also benefited by the BAPPENAS link to USAID, including improved cooperation and collaboration on program design efforts

Chapter 7 Possible Future Directions

The evaluation team believes that policy advice to the GOI still is a high pay-off activity. While BAPPENAS and BPS have benefited from nearly eight years of technical assistance, and while there is considerable evidence of increased capacity to generate data and analyze policy issues, all senior counterparts argued convincingly of the need for additional assistance. Recognizing the high pay-off to some continued support to BAPPENAS and DSP, it would appear prudent to continue supporting assistance to BAPPENAS until follow-on funding can be secured from another donor, most probably from either the Asia Development Bank or the UNDP. Short-term requests for assistance and the building of collaborative relationships with U.S. counterpart agencies should also be explored.

Advanced training in the U.S. for Indonesian economists is a highly complementary activity of policy advisory services. While the density of trained economists within the government is increasing, many are concerned that Ph.D. trained economists quickly move into governmental management positions or to the private sector, rather than remain in staff economist positions doing policy research. The returns to USAID and other donors supporting graduate education abroad remain high. If the U.S. continues to withdraw from long-term training, the gap will be filled by Japanese graduate education. This would tend to undermine the strong ties with U.S. universities that graduate education produces, and could eventually reduce the effectiveness of U.S. policy advisors.

While the original design of DSP II was probably premature in trying to open access to the discussion of economic policy issues, the time may be ripe now for trying again to strengthen university and private sector think tank capabilities. Very few private think tanks and private consulting firms are engaged in significant policy research, but their numbers and effectiveness appear to be increasing and they could significantly benefit from limited external support. Another possibility for broadening access and debate on issues would be to strengthen the economic capabilities of the legislative branch of government. Efforts in this direction have already been initiated by the Asia Foundation, working through private consultants to provide expert testimony to legislative hearings. A broad-based approach that supported university, think tank and private consultants' ability to contribute to more open policy discussions within government and in the legislature and press should be considered by USAID and the GOI in the near future.

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