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Australian Aid

INVESTING IN REGIONAL PROSPERITY:
POSITIONING THE AID PROGRAM TO SUPPORT AUSTRALIA'S ECONOMIC PARTNERSHIPS IN ASIA

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OFFICE OF DEVELOPMENT EFFECTIVENESS

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Cover photo: The new Australian Embassy in Jakarta taken in 2017.
Photo: John Gollings (from DFAT photo library)

The Office of Development Effectiveness
The Office of Development Effectiveness (ODE) is an office within the Australian Government Department of Foreign Affairs and Trade that is independent of aid program management. ODE monitors the Australian aid program's performance and evaluates its impact. ODE's work is overseen by the Independent Evaluation Committee, an advisory body that provides independent expert advice on ODE's evaluation strategy, work plan, analysis and reports.

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FOREWORD

Only a few middle-income countries (MICs) have successfully implemented reforms to reach advanced-economy level. Yet some donors are transitioning away from providing aid to MICs, and there is concern that Australia may follow this trend. MICs face significant development challenges and are home to almost three-quarters of the world's poor. They must implement widespread reforms to avoid stagnation, reduce inequality and continue to develop.

This evaluation puts forward a strong case for Australia to remain engaged with Asian MICs, and argues that Australia can continue to build its comparative advantage as a partner in economic and social reform. The rationale is driven by Australia's strategic interest in supporting prosperous and stable neighbours as well as the development needs of Asian MICs. The evaluation argues Australian aid can be positioned strategically to support the needs of Asian MICs and enhance our economic partnerships with these countries.

There are some examples of transformational results coming from Australian aid, where DFAT's assistance has supported partners to mobilise additional finance and improve public spending. But there are also challenges and areas for improvement in our engagement with Asian MICs. One area of particular interest is how DFAT's aid, trade and diplomacy work is aligned to support economic partnership objectives.

It has been five years since AusAID and DFAT integrated — this is a timely opportunity to examine how the department is working in a coordinated way and what can be learned from efforts to align aid, trade and diplomacy. These report findings make a valuable contribution to the conversation about aid's role in supporting Australia's economic partnerships in Asia.

Jim Adams
Chair, Independent Evaluation Committee

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ACRONYMS AND ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
AANZFTA	ASEAN Australia New Zealand Free Trade Area
AIPEG	Australia Indonesia Partnership for Economic Governance
AUSTRAC	Australian Transaction Reports and Analysis Centre
BAPPENAS	Ministry of National Development Planning (Indonesia)
DFID	Department for International Development
DFAT	Department of Foreign Affairs and Trade
EINRIP	Eastern Indonesia National Roads Improvement Project
GPF	Government Partnership Fund
GDP	gross domestic product
MAHKOTA	Towards a Strong and Prosperous Indonesia Society program
ODA	Official Development Assistance
ODE	Office of Development Effectiveness
OECD	Organisation for Economic Co-operation and Development
OOF	other official flows
ICAI	Independent Commission for Aid Impact
IndII	Indonesia Infrastructure Initiative
KSI	Knowledge Sector Initiative
MIC	middle-income country
MDB	Multilateral Development Bank
PPATK	Financial Intelligence Agency (Indonesia)
RCV	Restructuring for a More Competitive Vietnam
TNP2K	National Team for Accelerating Poverty Reduction (Indonesia)

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EXECUTIVE SUMMARY

As middle-income countries (MICs) progress towards more advanced economies, their need for external assistance changes. To sustain growth and manage rising inequality, MICs face complex policy challenges which call for new institutions and capacities. They have access to more development finance but are not necessarily equipped to use it to best effect.

Australia uses the term 'economic partnership' to refer to a maturing of its relationship with MICs. Though it has not been precisely defined, the term acknowledges a shared interest in deeper bilateral economic ties and mutual prosperity. For the Department of Foreign Affairs and Trade (DFAT), economic partnership is a framing concept that draws together its diplomatic, aid and trade work.

This evaluation assesses how Australian aid is evolving to support economic partnerships with Asian MICs. Looking at two case study countries—Indonesia and Vietnam—and through the Southeast Asia regional programs, it explores the transition away from the traditional donor-recipient relationship towards knowledge-based assistance, designed to support reform and help partner countries make better use of their own resources. While these trends are most advanced in Asian MICs, they are also present or emerging in other contexts in which Australia provides aid.

The evaluation also assesses what types of results are being achieved and what approaches are proving to be effective. The findings are pertinent to assessing the strategic case for Australia continuing to provide aid to Asian MICs.

REORIENTING DEVELOPMENT COOPERATION IN SUPPORT OF ECONOMIC PARTNERSHIPS

MICs such as Indonesia and Vietnam face a distinct set of development challenges. The pattern of growth that has brought them to middle-income status begins to slow, while inequality rises and new social challenges emerge, including around rapid urbanisation. To escape this 'middle-income trap', these countries need to move to a different type of growth, based on increasing productivity and competitiveness, while developing new social policy instruments. The challenge is not just technical but deeply political, requiring them to overcome vested interests that work against change. They may have a limited window of time to achieve this, while their demographic profile remains favourable and before an ageing population becomes a further constraint on growth. There is no guarantee that they will succeed: historically, only a few MICs have gone on to become advanced economies.

Many other bilateral donors, including Canada, Denmark, the Netherlands, Sweden the United Kingdom are choosing to concentrate their aid in low-income countries and fragile states. However, MICs are home to a growing proportion of the world's poor and will be essential partners for achieving the Sustainable Development Goals.

As Indonesia and Vietnam have gained more access to both domestic and international development finance, Australia's aid has fallen, absolutely and relatively. Australia has responded by shifting its focus away from supporting development results directly and towards knowledge-based assistance designed to support policy reform, build institutional capacity and raise the quality of national development spending. For example, Australia is moving away from financing infrastructure projects and towards helping its partners access multilateral development bank (MDB) loans and improve their own investments. Through flexible, problem-focused technical assistance, based on an understanding of political opportunities and constraints, Australia is positioning itself as a partner to reform-minded leaders and institutions. Through its regional programs, it supports the Association of Southeast Asian Nations' (ASEAN) objectives on trade, connectivity and economic integration.

While this is a balancing rather than a new approach to assistance, the evaluation finds that it meets the evolving needs of Indonesia and Vietnam. It also supports Australia's clear strategic interest in the progression of Asian MICs towards advanced economies within a prosperous and integrated region. The *2017 Foreign Policy White Paper* states that 'The Indo-Pacific encompasses our most important

economic partners and its dynamism supports economic growth in Australia, creating jobs and increasing our standard of living.' It also recognises that Australian security interests are closely tied to the stability of its neighbours, which could be threatened by rising inequality.

Rather than transitioning out of bilateral aid, there is a strong case for Australia remaining engaged and continuing to build its comparative advantage as a partner on economic and social reform. Indeed, there may be a case for re-establishing development cooperation with Asian MICs from which the aid program has already exited.

So far, however, the nature of and rationale for economic partnership in the two countries is not clearly articulated or understood, among counterparts or Australian stakeholders. Australian aid for Asian MICs needs to be supported by a more compelling narrative explaining both the development rationale and Australia's national interest.

Recommendation

1. DFAT should set out the long-term strategic case for development cooperation in support of economic partnerships with middle-income Asia, and how the quantum and approach to providing assistance might be expected to evolve as they develop.

ALIGNING AID, TRADE AND DIPLOMACY

Aligning aid with trade and diplomatic efforts, in pursuit of mutual prosperity, is an objective of Australia's economic partnerships.

Australia is a global proponent of using free trade to promote development, with development-friendly trade policies and a commitment to spending 20 per cent of its aid budget on aid for trade. ASEAN regional programs support implementation of the ASEAN Economic Community and promote regional connectivity in the Greater Mekong sub-region. So far, however, DFAT has not attempted to align bilateral aid behind its trade objectives in the two case study countries. It does not use aid programs to promote short-term trade or commercial interests and is careful to avoid perceived conflict of interest. Rather, DFAT takes the long view that promoting open, well-run economies with stable and effective governments is the best means of achieving Australia's long-term economic and security interests.

The evaluation suggests that this caution is appropriate. Using aid for short-term Australian interests would undermine the conditions for effective development cooperation, resulting in a loss of influence. To be an effective partner on economic reform, DFAT needs to maintain relationships of trust with key individuals and institutions at the centre of governments. The flagship economic governance programs in Indonesia and Vietnam do this well.

However, there is scope to strengthen the alignment of aid, trade and diplomacy in three ways.

First, there is potential to better align aid and diplomatic engagement to achieve the objectives set out in the *2017 Foreign Policy White Paper*. This is already occurring to a degree. In Indonesia, for example, DFAT has used opportunities created by the aid program to engage with senior policy makers and convey reform messages that support economic partnership objectives. Building on these efforts, there is scope for DFAT to use aid programs more effectively as platforms for diplomatic engagement, and to articulate its influencing goals more explicitly so they can be pursued more consistently and strategically through the aid program and diplomatic engagement.

Second, Australia is negotiating bilateral and regional free trade agreements that include provisions for broader economic cooperation, including pledges of Australian support to help partner countries take advantage of new trading opportunities by improving their business regulations and addressing supply-side constraints. These more ambitious trade agreements offer an opportunity to use Australian aid to promote reforms that will deepen trade and investment ties, with benefits to firms in both countries.

Third, there may also be scope for targeting aid towards sectors that offer opportunities for mutual benefit. Provided the interests of the two countries are complementary, rather than competitive, then it is legitimate to use aid to support partner country objectives in sectors that might eventually offer opportunities for Australian companies. In Indonesia, for example, Australian support for the vocational training sector could simultaneously create opportunities for Australian firms and help address skills gaps in the Indonesian labour force. However, it is important to be transparent about the Australian interests involved and ensure that programs follow both the international Official Development Assistance (ODA) definition and principles of good development practice. Successfully balancing the different interests requires some learning.

Recommendation

2. Within each of its economic partnerships with ODA-eligible countries, DFAT should:
    - » articulate influencing objectives and ensure that the messaging is consistent across its aid, trade and diplomatic engagements
    - » focus its aid for trade investments on helping partner countries to take advantage of opportunities in bilateral and regional free trade agreements
    - » look for opportunities to provide development assistance in sectors that offer the potential for mutual benefit, in ways that meet the conditions for good development practice.

DELIVERING RESULTS

The evaluation finds that knowledge-based assistance is making a useful contribution to supporting reform and improving national development expenditure in the case study countries. Policy making is a complex process and it can be difficult to determine how influential Australian assistance has been on specific reform outcomes. However, in Indonesia and Vietnam, Australian aid is providing quality technical and analytical inputs to support policy making and has, at times, been instrumental in the design and implementation of important reforms. There are many examples, but perhaps the most impressive is the work Australia has supported to improve the coverage and targeting of Indonesia's social protection system. This has underpinned President Widodo's successful efforts to ensure that only genuinely poor households receive electricity subsidies, leading to savings of approximately AUD1.6 billion for the national budget.

In Vietnam, the knowledge-based assistance is not as mature, but the work on competition policy is well positioned to address a major barrier to economic transition, which is the dominance of the economy by state-owned enterprises.

While the aid program can cite impressive achievements, it is important not to overstate the level of influence that can be achieved as an external actor. Policy making is unpredictable and subject to many factors beyond Australia's control. Knowledge-based assistance works by allying with national reformers and helping to improve their prospects of success, but even with reform constituencies to work with there are no guarantees that good reforms will proceed. Even when they do, support often needs to be sustained through implementation, to help guard against setbacks and reversals.

In the case study countries, the evaluation team assessed which approaches to knowledge-based assistance were proving to be effective.

- » **Economic governance facilities** play a central role in the economic partnerships, offering a flexible package of research and analysis, technical advice and capacity building services across a range of economic and social policy areas, and enabling Australia to position itself as a responsive partner to policy makers. They build relationships over time with key counterparts, with the flexibility to respond to reform opportunities as they emerge.
- » **Peer-to-peer partnerships** between Australian government institutions and their counterparts in the partner countries help to build lasting ties between institutions and individuals, to the benefit of both sides.
- » **Asian Development Bank and World Bank trust funds** help to boost their capacity to provide research and analysis to the partner countries. In the right conditions, this can improve the quality of other MDB finance.
- » **Infrastructure programs** are shifting their focus from the direct financing of investment projects towards influencing national systems and capacities and using Australian aid to unlock access to other finance. DFAT is still exploring how it can most effectively support Asian partners with their infrastructure needs.

No single type of program stands out as best suited to economic partnerships and a diversity of approaches may work best when the resources are available. Australia needs to invest in long-term relationships with a range of counterpart institutions, while retaining the flexibility to scale activities up and down as the context evolves. It also needs to be willing to take a low profile in helping national reformers to achieve their objectives. Programs are less convincing when they default to a train-and-equip approach to capacity building, in circumstances where capacity gaps are not the main constraint to institutional performance.

Given changes in the geopolitical and economic landscape, it remains to be seen how a mid-sized grant donor such as Australia can best use its resources to support countries with their infrastructure needs. There are a range of views about whether Australia still needs to fund some infrastructure development to be a credible partner. In Indonesia, the piloting of new practices (such as performance-based financing for local infrastructure) has led to some key changes in national infrastructure finance. On the other hand, simply funding high-quality infrastructure projects to demonstrate good practice has not always been an effective influencing approach, as there are limits on the extent to

which new practices can be adopted within government budgets and systems. With infrastructure finance an arena for geo-economic competition in the region, as identified in the *2017 Foreign Policy White Paper*, there is value in helping partner countries to become more informed customers of infrastructure finance.

Recommendations

3. DFAT should continue to develop the evidence base, technical expertise and guidance on the design and implementation of knowledge-based assistance, covering issues such as how to:
    - » analyse policy-making processes in partner countries and identify opportunities for knowledge-based inputs to support policy and institutional reform
    - » position aid programs to be useful partners to national reformers and build long-term relationships
    - » apply problem-solving approaches to assistance, combining short-term flexibility in activities and outputs with clarity in strategic objectives
    - » engage with and oversee implementers and multilateral partners
    - » design and implement influential pilots.
4. DFAT posts should encourage more interaction among their knowledge-based programs, for exchange of lessons and experience.

SYSTEMS AND CAPACITIES

Positioning aid to support economic partnerships calls for improvement in DFAT's systems and capacities in a number of areas.

Setting clear objectives: DFAT has not yet articulated specific goals for economic partnerships with countries, or agreed on those goals with the partner countries themselves. This hampers the closer alignment of aid, trade and diplomatic work. Adopting integrated country and regional strategies, which DFAT is considering, offers an opportunity to address this. For Asian MICs, the evaluation team considers that DFAT should develop strategies that will outline:

- » how Australia will support a country's transition to an advanced economy
- » Australia's long-term plans for building bilateral economic ties, including increasing overall trade and investment and promoting sectors of the economy that are of mutual interest
- » medium-term policy and institutional objectives, to be built into the objectives of relevant aid programs and addressed in diplomatic engagements
- » a possible case for region-wide strategies on issues and sectors where there is synergy between development objectives and Australian economic interests (such as tourism or education).

Analytical and diagnostic work: While the middle-income trap concept is a useful overarching description of the transition challenges facing Asian MICs, the dimensions of the trap and possible pathways for escaping from it are diverse. DFAT needs a more structured way of accessing good quality analysis of growth opportunities and constraints, drivers of inequality, political economy, and vulnerability to shocks and crises. This knowledge can be built over time but should be periodically synthesised and used to refresh economic partnership objectives.

Capacity and skills: The shift towards knowledge-based assistance arguably places greater management demands on DFAT posts, relative to the expenditure. Strategic oversight is needed to ensure that flexible programs remain coherent and aligned to economic partnership objectives. Australia also gains greater benefits, in terms of influence and reputation, if DFAT participates actively in managing counterpart relationships. While technical expertise can be sourced through aid programs, DFAT staff need sufficient understanding of economic and policy issues to be able to absorb the analysis they receive and to engage with policy debates. The establishment of cross-disciplinary communities of practice on economic and social policy issues would support this. DFAT would also benefit from making better use of the local knowledge and networks of its locally engaged staff.

Monitoring and reporting results: The evaluation team found that DFAT has taken useful measures to improve the monitoring and reporting of results from its knowledge-based assistance. The next step is to consider how to align these influencing results with the objectives of economic partnerships (once articulated) and institute periodic reviews of how well positioned DFAT is to achieve its objectives. It may be helpful to assign one of the economic governance programs the role of supporting monitoring and knowledge management across all relevant aid programs.

Recommendations

5. DFAT should ensure that future country and regional strategies for development assistance to MICs:
   - » are underpinned by suitable diagnostic work that identifies opportunities for, and constraints on, inclusive growth and transition to an advanced economy
   - » include a set of medium-term policy and institutional reform objectives, with a shared advocacy strategy to be pursued across aid, trade and diplomatic engagements and by other Australian government agencies where relevant
   - » identify sectors or areas where development cooperation can support national development goals and Australian economic interests.
6. DFAT should ensure that posts in economic partnership countries:
   - » have enough staff conversant on economic and social policy to engage in policy dialogue and manage knowledge-based programs and portfolios at a strategic level
   - » take measures to promote cross-disciplinary working, including with the trade area
   - » examine ways to take better advantage and further develop the capabilities of their locally engaged staff, as a critical resource for pursuing economic partnerships
   - » have access to country-level monitoring and knowledge-management tools to assess progress against key reform objectives, the significance of Australia's contribution, the ongoing relevance of its work and the health of the economic partnership.
7. DFAT should consider establishing a multidisciplinary community of practice among staff on economic partnerships, to share knowledge and experience on engaging with social and economic policy issues.

FUTURE AUSTRALIAN ASSISTANCE TO MIDDLE-INCOME COUNTRIES IN ASIA

The findings of the evaluation are relevant to ongoing discussions on the future of Australia's development cooperation with Asian MICs. While the evaluation team found consensus among DFAT stakeholders that support should continue, there were also widespread concerns that it is vulnerable to a loss of public and political support and that DFAT needs new ways of making the strategic case for continued aid.

This evaluation suggests three factors should be taken into account when considering future assistance to MICs in Asia.

First, nearly three-quarters of the world's poor live in MICs. Working with MICs will be essential for achieving global development objectives. While other bilateral donors are choosing to focus on low-income countries, Australia is well placed to develop its specialisation in knowledge-based assistance to help MICs in its region address their social and economic challenges. The case for this support is bolstered by the difficulties that MICs face in moving to advanced economies and the high risks of stagnation and even instability that they face. It should also be kept in mind that the capacity of these countries to cooperate in addressing regional challenges, such as climate change and cross-border health threats, will depend on their continued growth and development.

Second, this evaluation highlights the broad and deep relationships the aid program has cultivated with key decision-makers in case study countries, and the access this provides DFAT to prosecute Australian interests or work on issues of mutual interest. There will be financial and human resource costs to continuing to develop DFAT's expertise on economic and social policy. However, DFAT's representatives in-country are firmly of the view that these investments yield a positive return, in terms of Australia's profile and reputation, and help them to manage the patches of turbulence that afflict bilateral relationships from time to time. The lesson of lost relationships and access experienced by other donors who wound down their assistance to MICs abruptly is salient.

Third, the aid program provides scope to work on areas of reform within countries that have potential pay-offs for Australia's economic interests. Australian trade stands to benefit from measures that promote more open and prosperous national economies and greater regional economic integration. This evaluation suggests there may also be scope within economic partnerships to use aid more directly to promote bilateral economic ties.

These factors suggest that Australia should consider its approach to future development assistance carefully and not move towards a hasty exit based on income thresholds, as some donors have done. Rather, decisions should account for the risks Asian MICs face of stagnation or reversal, and the capacity of aid to help them overcome constraints on their development.

MANAGEMENT RESPONSE

DFAT welcomes this evaluation as valuable analysis of the evolving approach to Australia's development cooperation in Asia. The evaluation provides a strong case for continued long-term engagement with Asian middle-income countries (MICs) that is consistent with Australia's goals for sustainable economic growth and development in the region. It recognises a number of challenges and risks faced by MICs as their economies grow, including institutional deficits and rising inequality.

Australia is committed to long-term economic partnerships that help Asian countries address these challenges, achieve their own reform priorities and contribute to Australia's goals of a stable, prosperous and resilient region. We are focused on the ongoing needs of countries like Indonesia, the Philippines and Vietnam as they approach a challenging second stage of development associated with economic transition. Complex economic, social and structural reforms are necessary to sustain economic growth, tackle poverty and inequality, and maintain development gains. At the same time, there is risk of a development financing gap as these countries progressively experience reductions in funding and support from multilateral institutions as they 'graduate' from funding categories, and potentially withdrawal of other bilateral donors. Our partners will remain eligible for Official Development Assistance (ODA) for many years to come, enabling us to contribute our expertise in helping them to undertake economic and social reforms for their continued prosperity and stability.

DFAT also welcomes the evaluation's contribution to an evidence base on the most effective ways to deliver knowledge-based assistance. We welcome the evaluation's affirmation of the impacts that are already being achieved through our partnerships in Indonesia and Vietnam. This includes that Australia has broad and deep development relationships with decision-makers in these countries, our provisions of quality technical and analytical inputs to support the policy process, and our ability to tip the balance in favour of politically challenging and developmentally significant reform.

While not covered by the evaluation, our development partnerships in the Philippines and Sri Lanka also focus on knowledge-based assistance. In all these countries, Australia is promoting policy change and institutional development to meet the ongoing development challenges of the middle-income stage. Our emphasis is on helping our partners to maximise their own resources for inclusive growth and poverty reduction. Our reputation as a responsive and flexible development partner is key to our effectiveness in delivering knowledge-based assistance that makes a real difference to our partners.

Our other development partners in Southeast Asia—Myanmar, Cambodia, DPR Laos and Timor-Leste—are lower MICs which are also classified as least developed countries. We have the same focus on working as trusted partners through our assistance to help them tackle fundamental development challenges and lift their populations out of poverty.

The future direction of each economic partnership is being informed by Australia's *2017 Foreign Policy White Paper*, including the four tests for allocating development assistance: our national interest; promoting inclusive growth and reducing poverty; Australia's contribution adds value and leverages partner funding; deliver results and value for money. In building integrated economic partnerships we will consult with our partners and further consolidate our resources into sectors where we have strong interests, strong comparative advantage and the most ability to support positive change. A Southeast Asia Development Strategy is under development that responds to the changing needs and context of the region within the framework of Australia's foreign policy goals. This will be delivered through integrated development, trade and diplomacy efforts.

The evaluation provides a useful framework for DFAT to provide a more cohesive approach to economic partnerships through the improvements outlined in the recommendations.

Individual management response to recommendations

Recommendation 1		
DFAT should set out the long-term strategic case for development cooperation in support of economic partnerships with middle-income Asia, and how the quantum and approach to providing assistance might be expected to evolve as they develop.		
Response*: Agree		
Explanation	**Action plan**	**Responsible area(s) and timeframe**
DFAT is preparing an internal position paper on its development cooperation with MICs. It will include analysis on elements common to how we engage through development cooperation with MICs. How the quantum and approach to providing assistance might evolve as countries develop will depend on available budget resources and each country context and will be addressed through the development of aid investment plans.	Development Policy Division (DPD) has commenced work on an internal position paper on development cooperation with MICs. The Southeast Asia Development Strategy will set out Australia's approach to development cooperation in Southeast Asia for the next five years, in line with the Foreign Policy White Paper. While these strategies will discuss the approach to providing assistance, ultimately budget allocations are a decision of the Government as part of the annual budget process.	DFAT position paper—DPD, December 2018. Southeast Asia Development Strategy—Southeast Asia Division (SED), early 2019.

Recommendation 2		
Within each of its economic partnerships with ODA-eligible countries, DFAT should: » articulate influencing objectives and ensure that the messaging is consistent across its aid, trade and diplomatic engagements » focus its aid for trade investments on helping partner countries to take advantage of opportunities in bilateral and regional free trade agreements » look for opportunities to provide development assistance in sectors that offer the potential for mutual benefit, in ways that meet the conditions for good development practice.		
Response: Agree		
Explanation	**Action plan**	**Responsible area(s) and timeframe**
Australia's objectives for development cooperation in each country will be set out in updated aid investment plans, which will be informed by a broader consideration of Australia's aid, foreign policy and trade priorities for each bilateral relationship and overall integrated foreign policy goals set out in Australia's Foreign Policy White Paper and DFAT's Corporate Plan.	The Philippines will develop an updated aid investment plan in 2019. The Indonesia aid investment plan will be finalised in 2020 to align with the Indonesian Government's next medium-term development plan (2020–24). The aid investment plan will consider which Ministries we are seeking to work with and how these partnerships align with Australia's development, foreign policy and trade priorities.	SED, 2019 and 2020. South and West Asia Division, 2019.

* Agree/Agree part/Disagree

Explanation	Action plan	Responsible area(s) and timeframe
As found in the evaluation, Australia achieves development impact by focusing on sectors where we have a comparative advantage to add value to our partner government's priorities, including drawing on areas of Australia's expertise. We will continue to strengthen this as our economic partnerships evolve, guided by the Southeast Asian Development Strategy and the Foreign Policy White Paper. Australia has incorporated development cooperation and capacity-building assistance in trade agreements with partner countries to assist them to become more active partners in, and optimise the benefits from, these agreements. For example, the Association of Southeast Asian Nation (ASEAN)-Australia-New Zealand Free Trade Agreement (AANZFTA) includes an economic cooperation chapter and is supported by economic cooperation program funded by Australia and New Zealand. Other trade agreements under developed will have similar provisions. Australia has leveraged DFAT's partnership with the World Bank in Vietnam to initially provide modelling on the economic benefits of joining the Trans-Pacific Partnership and subsequently to assist the Government with implementation. Australia also takes account of partner country interests and needs in multilateral trading fora and our aid for trade investments support partner country trade deliberations. In Southeast Asia, our help to partner countries to take advantage of opportunities in bilateral and regional free trade agreements is complemented by investments focusing on country-specific constraints to growth, such as ease of doing business, competition and infrastructure.	The Vietnam aid investment plan is due to be updated in 2020 and will seek to build on the economic partnership that has evolved through the current aid investment plan in alignment with Vietnam's Socio-Economic Development Plan 2021–25. The current Sri Lanka aid investment plan 2015—19 has a strong focus on economic partnership. As DFAT drafts the next aid investment plan, planned for 2019–23, it will consider developing this further.	

Recommendation 3

DFAT should continue to develop the evidence base, technical expertise and guidance on the design and implementation of knowledge-based assistance, covering issues such as:

- How to analyse policy-making processes in partner countries and identify opportunities for knowledge-based inputs to support policy and institutional reform.
- How to position aid programs to be useful partners to national reformers and build long-term relationships.
- How to apply problem-solving approaches to assistance, combining short-term flexibility in activities and outputs with clarity in strategic objectives.
- How to engage with and oversee implementers and multilateral partners.
- How to design and implement influential pilots.

Response: Agree

Explanation	Action plan	Responsible area(s) and timeframe
DFAT is currently developing an Inclusive Growth and Governance Diagnostic (IGGD), which will include analysis of broader governance dynamics in a country, including policy-making processes. This will inform planning and strategy development. DFAT will refresh its Effective Governance Strategy to set a common approach across its political, trade and development functions in understanding the political economy of partner countries and using stakeholder-based approaches for development assistance. DFAT currently offers political economy analysis training in Canberra and at posts, which helps staff identify opportunities for inputs to support policy and institutional reform. DFAT will develop policy dialogue training, to build the capacity of DFAT staff to make constructive knowledge-based inputs to partner policy processes. DFAT is developing new guidance on capacity development, which will highlight the importance of taking a problem-solving approach to assistance.	The IGGD will be completed by end 2018, and the first joint diagnostic is likely in the first quarter of 2019. The Principal Specialist Governance will lead a process for refresh of the Effectiveness Governance Strategy by the end of 2018. The Indonesia program has developed a draft pilot tracking tool and is undertaking a review of its piloting practices. This review will be used to agree to clearer ways of working with the Indonesian Government to ensure pilots are appropriate and influential. The Indonesia program currently uses the Significant Policy Change process to measure the performance of knowledge-based assistance. To strengthen understanding of the policy-making process in Indonesia and the most effective ways to support institutional reform, the Indonesia program plans to undertake a meta-analysis of the first three years of Significant Policy Change results. The Southeast Asia Division will explore methods for measuring Australia's contribution to policy change through development cooperation for all economic partnership programs indicators.	IGGD—DPD and Multilateral development and finance division (MDD), early 2019. Governance Strategy refresh—DPD, early 2019. Policy dialogue training—DPD, May 2019 (subject to resources). Capacity development guidance—DPD, end 2018. Indonesia program reviews—SED, 2019. Policy change contribution method for Southeast Asia programs—SED, 2019.

Recommendation 4

DFAT posts should encourage more interaction among their knowledge-based programs, for exchange of lessons and experience.

Response: Agree

Explanation	Action plan	Responsible area(s) and timeframe
DFAT acknowledges the value in continuing to build evidence and understanding of effective knowledge-based approaches, and will work to strengthen this through existing processes such as country-level Performance Assessment Frameworks and Aid Quality Checks. DFAT will establish a Working Group on Adaptive Programming to facilitate more interaction among programs.	SED will explore the merits of including policy influence indicators in Performance Assessment Frameworks to support knowledge and learning. Additional opportunities to facilitate cross-programs exchanges will be sought—for example, the internal Southeast Asia Development Conference.	Adaptive Programming Working Group—DPD and Contracting and aid management division end 2018. Policy influence indicators—SED, 2019.

Recommendation 5

DFAT should ensure future country and regional strategies for development assistance to MICs:

- are underpinned by suitable diagnostic work that identifies opportunities for, and constraints on, inclusive growth and transition to an advanced economy
- include a set of medium-term policy and institutional reform objectives, with a shared advocacy strategy to be pursued across aid, trade and diplomatic engagements and by other Australian Government agencies where relevant
- identify sectors or areas where development cooperation can support national development goals and Australian economic interests.

Response: Agree

Explanation	Action plan	Responsible area(s) and timeframe
The IGGD tool will help country teams conduct robust economic and political-economy analysis to underpin their strategic development, providing a comprehensive analytical tool to inform preparation of aid investment plans together into one tool. DFAT also draws heavily on the analysis of the World Bank, International Monetary Fund, Asian Development Bank and other institutions regarding constraints to growth, inclusiveness and policy reform.	DPD is working with two posts to develop and field-test the AMIC Framework by early 2019. The Indonesia Program is working with the Development Economics Unit to produce a constraints-to-growth analysis to inform the next aid investment plan. The aid investment plan will consider objectives for Australian aid, including policy and institutional reform, which can be pursued across all of Australia's relevant engagements in Indonesia.	IGGD—DPD and MDD, early 2019. AMIC Framework—DPD, early 2019. Indonesia aid investment plan—SED, 2020.

Explanation	Action plan	Responsible area(s) and timeframe
DFAT, together with The Asia Foundation, is currently developing an Advanced Middle Income (AMIC) Framework that will analyse the political dynamics of economic transitions, and help to identify options for engagement. This process is being supplemented by a workshop series to trial new methods of engaging on middle income issues. The Southeast Asia Development Strategy will identify priority objectives for Australia's development cooperation in South East Asia to achieve Australia's foreign policy goals (as set out in the Foreign Policy White Paper). The focus for development assistance to each country will then be determined according to where partner governments are seeking our assistance, Australia's national interest and where Australia has strengths specific to each context. The current Sri Lanka aid investment plan (2015–19) already adopts an integrated advocacy approach, as will the next aid investment plan. Southeast Asian programs will incorporate an integrated advocacy approach into preparation of future strategies.		

Recommendation 6

DFAT should ensure that posts in economic partnership countries:

- have enough staff conversant on economic and social policy to engage in policy dialogue and manage knowledge-based programs and portfolios at a strategic level
- take measures to promote cross-disciplinary working, including with the trade area
- examine ways to take better advantage and further develop the capabilities of their locally engaged staff, as a critical resource for pursuing economic partnerships
- have access to country-level monitoring and knowledge-management tools to assess progress against key reform objectives, the significance of Australia's contribution, the ongoing relevance of its work and the health of the economic partnership.

Response: Agree

Explanation	Action plan	Responsible area(s) and timeframe
To be effective in knowledge-based assistance, DFAT recognises the need for staff to be skilled in policy engagement and advocacy, as well as strong aid management capability. Highly qualified technical specialists in key sectors for technical credibility and senior locally engagement staff for continuity of relationships and country understanding are also necessary. DFAT's Five-year Workforce Strategy (launched January 2018) seeks to strengthen development capability and career pathways in DFAT. The Strategy describes the development of 'capability anchors' for staff members, that is, development of areas of deep knowledge or expertise. A workforce plan for international development capability is currently being drafted by DFAT, defining an international development 'capability anchor' and outlining a first phase of actions required to build and deploy international development capability across the department. An International Development Capability task group was established (July 2018) to lead the first phase of work to build development capability consistent with the draft workforce plan for international development. DFAT recognises the need for better trade skills in posts and better integration of trade and development cooperation. This will be pursued through integrated strategies. DFAT will explore how trade negotiations and development efforts can better support partners towards openness and reform.	International Development Capability Task Group key planned actions include reviewing mechanisms for posts to secure external technical expertise and building international technical experts in key sectors. It will also initiate a trail International Development Officer Program, seeking to build staff development capability through a program of work rotations, complemented by mentoring and formal learning. DFAT's Indonesia program is leading new practice in measuring the impact of knowledge-based assistance through the Significant Policy Change method. As above, the Southeast Asia Division will explore improvements to country-level monitoring of knowledge-based assistance through policy influencing indicators. Internal policy thinking on opportunities to better link up trade and development cooperation efforts.	International Development Capability Task Group—Corporate Management Group. Country-level monitoring in Southeast Asia—SED, 2019.

Recommendation 7		
DFAT should consider establishing a multidisciplinary community of practice among staff on economic partnerships, to share knowledge and experience on engaging with social and economic policy issues.		
Response: Agree		
Explanation	**Action plan**	**Responsible area(s) and timeframe**
DFAT will commence a Working Group on Adaptive Programming. It will enable knowledge-sharing among program teams, including programs seeking to influence policies and the use of evidence in policy making.		Adaptive Programming Working Group—DPD and ACD, end 2018.

1. INTRODUCTION

In recent years, the term 'economic partnership' has been used to describe the relationships that Australia seeks to build with MICs in the Asia-Pacific region and beyond. Though it has not been precisely defined, it refers to a maturing of bilateral relations, based on shared interests and closer economic ties. For DFAT, the term is a framing concept that encompasses diplomatic engagement, trade initiatives and development cooperation.

This evaluation explores how Australia's development cooperation is evolving to support economic partnerships in two Asian countries, Indonesia and Vietnam, and through the Southeast Asian regional program. As MICs, Indonesia and Vietnam have increasing access to development finance and are no longer dependent on aid. However, they also face complex development challenges—a consequence of rapid economic and social change and residual poverty—and their progression towards advanced economies is by no means guaranteed. Of 101 MICs that existed in 1960, only 13 had achieved high-income status by 2008.[1] The *2017 Foreign Policy White Paper* articulates Australia's strong interest in the continuing growth and stability of its Asian neighbours and in an open and prosperous regional economy.[2]

The evaluation explores the rebalancing of development cooperation in Indonesia and Vietnam towards knowledge-based assistance, in response to declining Australian aid budgets and changing partner needs. It assesses what kinds of results are being achieved, and which approaches are proving to be effective. While this rebalancing is most advanced in Asian MICs, the findings of the evaluation may also be relevant to other contexts in which Australia provides aid.

> **AUSTRALIA WILL CONTINUE TO BENEFIT FROM THE COMPLEMENTARITY OF OUR ECONOMY WITH THOSE OF OUR NEIGHBOURS. ASIAN ECONOMIC GROWTH, URBANISATION AND EXPANDING MIDDLE CLASSES WILL SUSTAIN OR INCREASE DEMAND FOR MINERALS AND ENERGY, PREMIUM AGRICULTURAL PRODUCTS, AND SERVICES.**
>
> ***2017 Foreign Policy White Paper***

Some Asian MICs, such as Vietnam, faced an exodus of bilateral donors once they reached the middle-income threshold. In the past, Australia phased out bilateral aid to Thailand.[3] In the coming years, Australia will need to choose whether to continue to provide aid to countries such as Indonesia and Vietnam. The findings of this evaluation are relevant to the question of whether there is still a case for Australian aid to Asian MICs and, if so, what it should look like.

1 World Bank and the Development Research Centre of the State Council, *China 2030: Building a Modern, Harmonious, and Creative High-Income Society,* 2012.

2 DFAT, *2017 Foreign Policy White Paper*, Australian Government, November 2017, p. 4.

3 Australia phased out bilateral aid to Thailand in 2004–05, on the initiative of the Thai Government. Gross national income per capita (constant 2010 USD) at that time was USD4,100: *World Bank data.*

DEVELOPMENT COOPERATION AND ECONOMIC PARTNERSHIP

Australia's 2014 aid policy recognised that dramatic economic and geopolitical shifts, both in Asia and across the globe, called for 'a new development paradigm'.[4] With global aid flows dwarfed by domestic revenues, foreign direct investment and remittances, Australia concluded that the future role of aid was as a catalyst for mobilising other resources in support of economic growth and poverty reduction. Policy placed a strong emphasis on using aid to promote increased trade. It called for more mature partnerships with both developing country governments and the private sector. It stressed the need for aid to be nimble and innovative, using knowledge-based assistance to achieve systemic development pay-offs.

WE HAVE ALIGNED THE GOAL OF POVERTY REDUCTION WITH THE PURSUIT OF REGIONAL ECONOMIC GROWTH. THIS GOAL IS IN AUSTRALIA'S NATIONAL INTEREST, AS WELL AS UNAMBIGUOUSLY IN THE INTEREST OF OUR REGION AND IT IS CONSISTENT WITH OUR FOCUS ON 'ECONOMIC DIPLOMACY'. JUST AS TRADITIONAL DIPLOMACY SEEKS TO PROMOTE PEACE, ECONOMIC DIPLOMACY SEEKS TO PROMOTE PROSPERITY.

The Hon Julie Bishop MP, Minister for Foreign Affairs, Speech to the National Press Club, 18 June 2014

The use of 'economic partnership' as an overarching framework for this new aid paradigm first appeared in DFAT's May 2015 budget narrative. This talked of the need for a differentiated approach. In the case of the Pacific, this meant a continuing commitment to traditional development assistance. In the case of growing Asia, this has meant a shift towards economic partnerships.

The economic partnership narrative emerged against the backdrop of large reductions in the 2015–16 aid budget. With cuts of up to 40 per cent to Asian countries, shifting from funding services and development projects directly towards catalysing other resources was identified as a means of maintaining impact and influence. In a 2016 speech, the then DFAT Secretary spoke of the opportunity for Australia to position itself as an ally of economic reformers across the region, with its standing as partner of choice determined by the quality of its assistance, rather than the quantity.[5] The term economic partnership also reflects DFAT's goal of using Australia's diplomatic, trade and aid resources in 'complementary and mutually reinforcing' ways.[6]

WE MUST RECOGNISE THAT THE GROWING RESOURCES AVAILABLE TO [ASIAN MICS] NECESSITATE CHANGE IN HOW AID IS DELIVERED IN ORDER FOR IT TO REMAIN EFFECTIVE … AUSTRALIA IS WELL PLACED TO SUPPORT THE ECONOMIC REFORM AND DEVELOPMENT AGENDAS IN THE REGION. AUSTRALIA'S ECONOMIC AND BROADER PUBLIC POLICY INSTITUTIONS ARE INTERNATIONALLY RECOGNISED. BUILDING ON THE PARTNERSHIPS AT THE INSTITUTIONAL LEVEL BETWEEN OUR ECONOMIC POLICY MAKERS AND REGULATORS AND THOSE IN THE REGION IS A GREAT OPPORTUNITY FOR AUSTRALIA. IN WHAT WILL BECOME AN INCREASINGLY CONTESTED SPACE THERE WILL BE EVEN MORE PREMIUM PLACED ON BEING A RELIABLE PARTNER.

Peter Varghese, Secretary of the Department of Foreign Affairs, Speech to the 2016 Australasian Aid Conference, 10 February 2016

4 The Hon Julie Bishop MP, Minister for Foreign Affairs, 'Ministerial Foreword' in DFAT, *Australian aid: promoting prosperity, reducing poverty, enhancing stability,* Australian Government, June 2014.

5 Peter Varghese, Secretary of DFATs, *speech to the 2016 Australasian Aid Conference*, 10 February 2016.

6 DFAT, *Australian aid: promoting prosperity, reducing poverty, enhancing stability,* Australian Government, June 2014, p. 9.

The 2017 Foreign Policy White Paper[7] uses the term economic partnership to refer to deepening trade and investment links with Asian countries and others around the world. At times, it also uses the term more narrowly to refer to free trade agreements. The white paper stresses that Australia has an interest in 'an open, outward-looking regional economy' to maximise growth and guard against the dangers of strategic rivalry. It states that Australia will stand against protectionism by championing an open, rules-based international trading system and pursuing the long-term goal of a region-wide free trade area.

PURPOSE AND SCOPE OF THE EVALUATION

The purpose of the evaluation is to explore the role that aid plays in supporting Australia's economic partnerships in Indonesia and Vietnam, and what kinds of results are being achieved. It also looks at what progress is being made in aligning aid, trade and diplomatic initiatives. It takes an exploratory approach, recognising that economic partnership is still emerging as an organising concept for the Australian aid program that refers to a direction of travel, rather than a defined destination.

The scope of the evaluation was based on consultations with DFAT stakeholders, who identified these objectives:

- assist DFAT to further articulate the economic partnership concept
- explore whether DFAT is using its aid, trade and diplomatic instruments in complementary ways, and whether its capacities and systems facilitate this
- explore what kinds of results are being achieved within economic partnerships, and which approaches to supporting policy and institutional reform are proving effective.

The scope of the review is not limited to economic sectors or economic growth-related objectives. The changes in the aid program analysed relate to its methods—in particular, a shift towards knowledge-based assistance—and apply equally to Australian support on social policy or public services.

EVALUATION QUESTIONS

1. Relevance: How is Australian support evolving towards economic partnerships with Asian MICs, and what might they become?
   - What are the emerging elements of economic partnerships with Asian middle-income countries?
   - How are emerging economic partnerships reflecting the interests and priorities of Australia and the partner countries?
   - What scope exists to improve the complementarity of aid, diplomatic and trade initiatives? What are the opportunities and risks presented by available options for improving complementarity?
2. Effectiveness: What approaches have proved most effective in building economic partnerships?
   - What types of results has the Australian aid program been able to achieve through its shift towards economic partnerships?
   - What strategies and approaches have proved most effective at leveraging other resources and building policies and institutions to support inclusive growth?
   - How well do DFAT's systems and capacities facilitate its economic partnerships?

EVALUATION METHODS

The evaluation began with an analysis of the changing context for Australia's development cooperation in Asia. Through a literature review, and drawing on DFAT's ongoing work with The Asia Foundation, the evaluation examined the development challenges facing MICs and their changing development finance needs. As comparators, it considered how a group of like-minded bilateral donors—specifically, Canada, Denmark, the Netherlands, Sweden and the United Kingdom—are adapting the amounts, types and objectives of development assistance to MICs, based on development policies and other published sources. As these changes to the context for development assistance are important to the evaluation conclusions, they are detailed in Chapter 2.

7 DFAT, *2017 Foreign Policy White Paper*, Australian Government, November 2017.

The evaluation's core focus was case studies of Australia's aid to Indonesia and Vietnam, with one-week visits to each in August 2017, and a desk review of aspects of the Southeast Asia Regional aid program. The evaluation team reviewed a sample of 14 programs (Annex A), selected from a list identified by Bangkok, Hanoi and Jakarta posts as characteristic of how Australian aid has evolved within economic partnerships.[8] The sample was chosen to cover the subject areas of economic governance, social protection, infrastructure and the business environment as well as approaches to knowledge-based assistance.

In each country, the evaluation team interviewed DFAT staff, key stakeholders from government and other development partners on their understanding of economic partnership and the role of knowledge-based assistance. For each of the programs in the sample, the evaluation team reviewed program documentation and interviewed the responsible DFAT staff, implementing partners, national counterparts and other partners.

The evaluation team also conducted two visits to DFAT in Canberra, interviewing key stakeholders from across the department and conducting two consultations, including a final workshop on the evaluation findings and recommendations. Altogether, around 130 key stakeholders were interviewed (Table 1).

Assessing the results of knowledge-based assistance is challenging, owing to the complexities of national policy processes. The evidence in this evaluation is drawn from program reporting and interviews with the responsible DFAT staff, triangulated to the extent possible with documentary evidence and feedback from national stakeholders. However, the evaluation was not designed to test all results claims rigorously and there may be some risk of positive bias.

Table 1: Key stakeholders interviewed for this evaluation

Stakeholder group	Canberra	Indonesia	Vietnam	Total
DFAT	19	24	13	56
Other Australian government departments		3	5	8
Government officials » Indonesia: Ministry of National Development Planning (BAPPENAS), Coordinating Ministry for Economic Affairs, Ministry of Finance, Indonesian Financial Transaction Reports and Analysis Centre » Vietnam: Ministry of Planning and Investment, Ministry of Foreign Affairs, Ministry of Finance, Ministry of Industry and Trade, Ministry of Transport, Vietnam Competition Authority. Quasi-government bodies: Vietnam Business Forum; Central Institute for Economic Management		6	14	20
Development partners » Asian Development Bank, Canada, France, Germany, Ireland, the Netherlands; New Zealand, United Kingdom; United States, World Bank		7	4	11
Implementers » Includes contractors, grantees and other stakeholders involved in programs	2	33	8	43

8 Some additional programs were identified as relevant during the field visits.

2. CONTEXT: AID TO MIDDLE-INCOME COUNTRIES

Among donors, there is debate on the merits of continuing aid to MICs as they progress towards developed economies.

As domestic revenues and access to external finance grow, MICs become less dependent on aid to fund their development. In an era of widespread public scepticism towards aid, it is increasingly difficult to make a political case for financial assistance to countries that are emerging as economic powers in their own right.

Box 1: What are middle-income countries?

MICs are those with a per capita gross national income of between USD1,006 and USD12,235. They are a diverse group, in terms of size, population and level of development. They are home to around 5 billion people, produce one-third of global gross domestic product (GDP) and are a major source of global growth. However, they also account for 73 per cent of the world's poor. Inequality within MICs is a leading cause of global poverty and may prove to be one of the most difficult obstacles to achieving the Sustainable Development Goals.

Historically, only a small number of countries have made the transition from MICs to advanced economies. The difficulty of doing so has come to be referred to as the 'middle-income trap'.

Most of the Asia-Pacific countries that receive Australian aid are above the middle-income threshold. This evaluation focuses on Asian MICs, which face a distinct set of social and economic challenges.

Source: World Bank, Middle-Income Countries—Overview, March 2018; William Cole, *Advanced Middle Income Countries in Asia: Challenges and Opportunities Ahead*, The Asia Foundation, May 2017 (unpublished).

On the other hand, MICs are home to 73 per cent of the world's poor (Box 1) and this proportion will increase in the coming years as more countries reach the middle-income threshold. That makes MICs indispensable partners in achieving the Sustainable Development Goals. MICs also confront difficult development challenges and may have a limited window of time to address them before rising inequality and unfavourable demographics make them even more difficult to solve.

This section describes the context for Australia's pursuit of economic partnerships in Asia, including changing patterns of development finance, the development challenges facing MICs and how other bilateral donors are responding.

CHANGING PATTERNS OF DEVELOPMENT FINANCE

ODA from all donors reached a high of USD142 billion in 2016, representing a doubling of aid levels from the turn of the century.[9] In spite of this, even larger increases in domestic revenues and foreign direct investment have meant that aid now accounts for a much smaller share of the finance available to developing countries than it did 15 years ago, especially for MICs.[10]

These trends are clearly visible in Asian MICs such as Indonesia and Vietnam. Both have achieved strong growth over the past decade, averaging 5.6 per cent and 6 per cent respectively (2007–16).[11] This has translated into significant increases in public revenue. Indonesia's tax revenue increased fourfold between 2007 and 2015, while Vietnam's has more than doubled.[12] Foreign direct investment has also increased: In Indonesia, it leapt from USD4.9 billion in 2009 to USD25 billion in 2014, before suffering falls in 2015 and 2016.[13]

9 OECD, *Development Co-operation Report 2017*, p. 139.

10 ODI et al., *European Report on Development 2015*, 2015, pp. 96–101.

11 Authors' calculation based on World Bank data. *World Bank Databank*, World Bank, 2017.

12 *Revenue Statistics*, OECD. Stat [accessed 19 December 2017]. Marcus Cox and Tran Thi Hanh, *Development Finance for Sustainable Development Goals in Middle-Income Viet Nam*, UN, Multidimensional Poverty Index and European Union, December 2014.

13 Foreign direct investment, net inflows (balance of payments, current USD); .

These trends have reduced reliance on ODA. As a share of the national budget, ODA reached a peak of 28 per cent in 1988–89 for Indonesia and had declined to just 4 per cent by 2008, while in Vietnam it fell from 25 per cent in 2003 to 11 per cent in 2013.[14]

Organisation for Economic Co-operation Development (OECD) donors have responded to the region's growth performance by reducing ODA to Southeast Asia from its peak of USD9.4 billion in 2013 to USD6 billion in 2016.[15] MDBs are the largest source of ODA to Vietnam and Indonesia, but the terms of their support are changing. Indonesia graduated from the World Bank's concessional window in 2009[16], while Vietnam graduated in 2017 (but will have access to 'blended' finance for a transitional period). OECD donors have begun to phase out their assistance to most countries in the region, with the exception of the regional donors, Australia, Japan and Korea.

CHINA AND INDIA

China and India have become major new players in the region. The White Paper notes that economic growth in Asia has been accompanied by increased 'geo-economic competition', with trade, investment and infrastructure finance used as instruments to build strategic influence and secure commercial advantage.

A new database[17] of Chinese aid and 'other official flows' shows at least USD64.4 billion spent in Southeast Asia between 2000 and 2014, of which USD11.5 billion was 'ODA-like'. Of China's total flows, USD17 billion was spent in Indonesia on 86 projects, at an average of USD2.5 billion per year. By comparison, Australian aid to Indonesia was USD376 million for 2015, and Indonesia's total ODA receipts were USD13.5 billion in the same year.[18] Vietnam is cautious in accepting Chinese finance but has still accepted USD4.2 billion in Chinese loans over the 15-year period for which data is available. A number of countries in the region are much more dependent on Chinese support; in Cambodia, for example, Chinese investment reportedly accounts for 70 per cent of all industrial investment.[19]

Chinese support is heavily focused on infrastructure. In Indonesia, it has financed bridges, roads, power plants and railway projects, all designed and constructed by Chinese firms. The only exceptions have been a slum improvement project financed through the Asian Infrastructure Investment Bank, the establishment of Confucius institutes at Indonesian universities, and scholarships for Indonesian students to study in China.[20]

India has increased its focus on Southeast Asia. It has concluded bilateral trade agreements with ASEAN and a number of individual states. India is also funding transport projects in several ASEAN countries, to support connectivity. Its trade with ASEAN has grown to USD70 billion in 2016-17.[21] While Chinese and Indian loans may offer opportunities for developing countries, it is in Australia's interest that they are fair and transparent in their terms and avoid creating unsustainable debt burdens.[22]

THE MIDDLE-INCOME TRAP

According to the literature, as they progress towards upper middle-income status, MICs are likely to encounter a set of conditions that hamper their continued economic growth, leading to a middle-income trap. Over the same period, their growth tends to become less pro-poor in nature, leading to rising inequality. There are various explanations for this phenomenon and varying evidence as to the level of income at which it occurs.[23] However, the existence of a middle-income trap is widely accepted, appearing in more than 300 articles. The literature is more relevant to Asian MICs than to Pacific countries, due to their size, level of industrial development and regional context. While Pacific MICs may also face constraints on their growth, they are likely to be of a different nature.

DFAT-funded research by The Asia Foundation explains the difficulty that MICs face in sustaining growth.[24] Countries such as China and Vietnam escaped low-income status through a change in the structure of their economies from low productivity agriculture into light manufacturing. Mass

14 Authors' calculations based on *World Bank Databank*, World Bank, 2017.

15 *OECD data.*

16 Indonesia first graduated in 1980 but was again given access to blended finance in 1999 following the Asian financial crisis, before a second graduation in 2009.

17 Authors' calculations based on Axel Dreher et al., '*Aid, china, and growth: evidence from a new global development finance dataset'* AidData Working Paper, no. 46, Williamsburg. 2017.

18 OECD, *Geographical Distribution of Financial Flows to Development Countries*, 2017, p. 186.

19 '*Why Cambodia has cosied up to China*', The Economist, 21 January 2017.

20 Pierre van der Eng, '*Why does Indonesia seem to prefer foreign aid from China?*', *East Asia Forum*, 2 December 2017.

21 Indian Ministry of External Affairs, *ASEAN-India Relations,* ASEAN India, 25 Years, 2017.

22 DFAT, *2017 Foreign Policy White Paper*, Australian Government, November 2017, pp. 44–45.

23 Barry Eichengreen, et al., *Growth slowdowns redux: new evidence on the middle-income trap*, National Bureau of Economic Research, 2013.

24 William Cole *Advanced Middle Income Countries in Asia: Challenges and Opportunities Ahead*, The Asia Foundation, May 2017 (unpublished); Richard Doner and Ben Schneider, '*The middle-income trap: more politics than economics*', *World Politics,* vol. 68, no. 4, 2016, pp. 1–37.

employment in low-skilled sectors such as textiles was the driver of large-scale poverty reduction. After a period of industrial development, however, MICs face a point where the supply of surplus labour begins to dry up, wages increase, and the economy loses its labour-cost advantage. This typically occurs at an income level of around USD4,000 per capita (although other factors, such as natural resource wealth, can delay it). From that point, continued growth requires a further structural shift towards more specialised, higher-productivity manufacturing. While this was achieved by 'Asian tigers' such as Singapore and South Korea, most MICs find it very difficult.

Escaping the middle-income trap requires the rapid development of more sophisticated policies and institutions.[25] Government intervention is needed to stimulate entrepreneurship, attract new technologies, build human capacity, upgrade infrastructure, improve the business environment and manage rapidly growing cities. These are expensive reforms that call for increases in tax revenues and public expenditure. This phase of development is also associated with rising inequality—a pattern already visible in both Indonesia and Vietnam[26], which can create new sources of social and political tension. Countries reach this point in their development with deep institutional deficits (Box 2).

Early-stage industrialisation can be achieved with a basic endowment of public institutions. The next phase of development, however, calls for much more sophisticated institutions. The Asia Foundation calls this the 'S-curve' of institutional development (Figure 1). Overcoming this institutional deficit is a deeply political challenge. Industrialisation creates new business and bureaucratic elites able to influence public policy in their own interest, creating barriers to entry and preventing the 'creative destruction' needed to move to a more productive economy.[27] The rise of the middle class[28] and the politicisation of inequality can lead to a fragmentation of politics[29], making it more difficult to change policy direction.[30] These political challenges are likely to manifest in different ways in different countries, requiring different approaches to external support.

Box 2: Institutional deficits in Vietnam

Since the launch of its economic reforms in the 1980s, Vietnam has been one of the most dynamic economies in the world, sustaining growth rates above 7 per cent over a 20-year period and quadrupling the size of the economy. The growth in low-skilled manufacturing resulted in poverty declining by 2.9 percentage points per year, from 58 per cent in 1993 to 13.5 per cent in 2014.[31] Yet as the country begins to lose its low-cost labour advantage, its ability to transition to a new development path is held back by deep institutional constraints.

- Vietnam's transition to a market economy remains incomplete, and state ownership of major enterprises, large budget deficits and high rates of public debt crowd out the development of an indigenous private sector.
- According to World Bank measures, regulatory quality has improved little over the past 20 years.
- Public investment remains highly inefficient, owing to an inadequate legal framework for investment management, weak planning and budgeting, and coordination challenges across 63 provinces. Political economy pressures lead to many public investment projects being launched but never completed.
- To fund the expansion of public services, both formal user charges and informal co-payments have increased, creating problems of access and equity.
- While foreign direct investment is high, it is dominated by low value-added assembly operations that bring few wider economic benefits (such as technology transfer or building local supply chains).

Source: Cox and Hanh, *Development finance for sustainable development goals in middle-income Viet Nam*, 2014

25 Cole, *op. cit.*, pp. 7–10.

26 World Bank, *Indonesia's Rising Divide*, March 2016. Nguyen Tran Lam, *Even it up: How to tackle inequality in Vietnam*, Oxfam, January 2017.

27 Yikai Wang, '*The political economy of the middle-income trap: implications for potential growth*', Asian Development Review, vol. 33, no. 2, 2016, pp. 167–181.

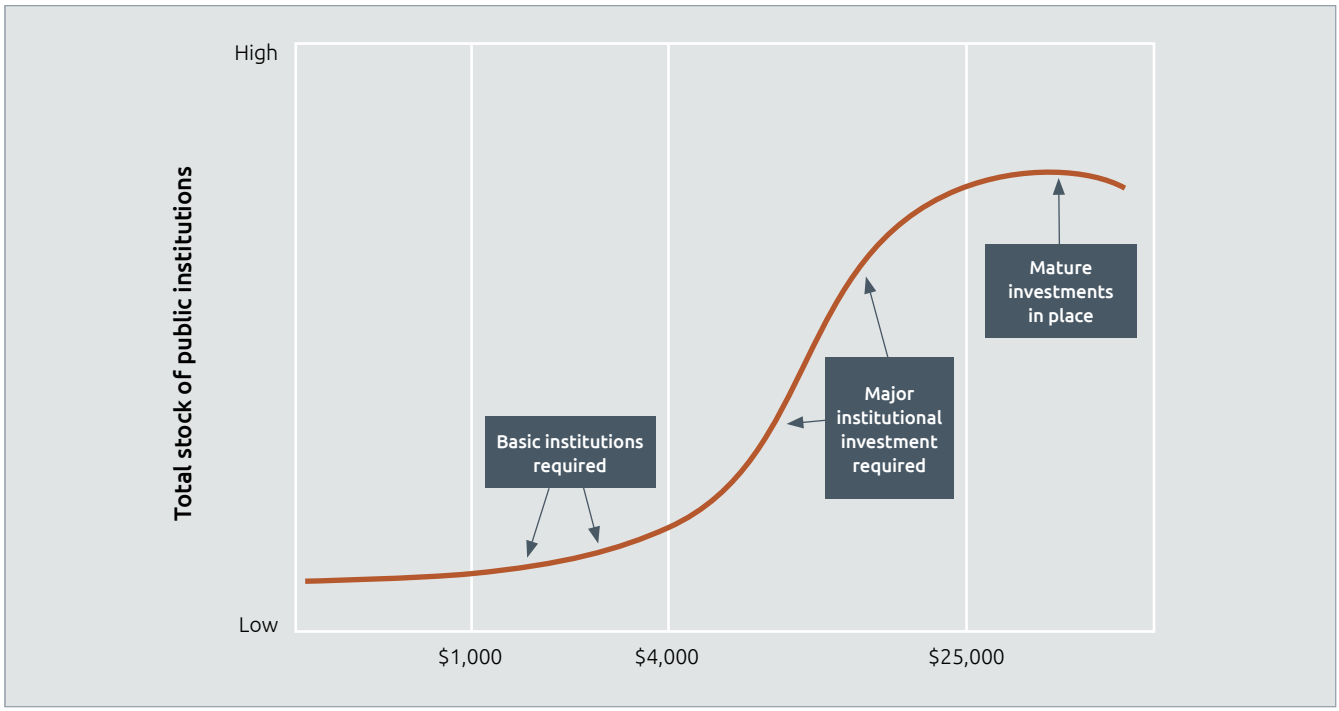
28 DFAT-funded World Bank research notes that one in every five Indonesians, or 52 million people, are now middle class, with incomes above purchasing power parity of USD15 per day: World Bank, *Aspiring Indonesia: Expanding the Middle Class, 2018* (unpublished). World Bank research suggests that the middle class is growing rapidly in China, Malaysia, Thailand and Vietnam, but only slowly in Cambodia, Indonesia and the Philippines: World Bank, *Riding the Wave: An East Asian Miracle for the 21st Century*, 2018, p. 2.

29 Richard Doner and Ben Schneider, '*The middle-income trap: more politics than economics*', *World Politics*, vol. 68, no. 4, 2016, pp. 1–37.

30 William Cole, *Advanced Middle Income Countries in Asia: Challenges and Opportunities Ahead,* The Asia Foundation, May 2017, pp. 12–13 (unpublished).

31 World Bank, *Vietnam—Overview*, 2018.

Figure 1: The S-curve of institutional development



Adapted from: William Cole, *Advanced Middle Income Countries in Asia: Challenges and Opportunities Ahead*, The Asia Foundation, May 2017 (unpublished).

MICs can also face shortfalls in development finance. While the rise in domestic revenues eventually more than compensates for the loss in ODA, MICs go through a period where their overall development finance stagnates and even declines, before recovering again. Kharas describe this as the 'missing middle' of development finance (Figure 2).[32] As a group, MICs are poor at tax collection. For example, Bangladesh, Indonesia, the Philippines and Sri Lanka all have tax-to-GDP ratios of below 15 per cent[33], which is viewed as the minimum required to cover basic state functions. OECD countries average 34 per cent.[34]

MICs have a limited window of time to address these challenges. Initially, they enjoy a 'demographic dividend', where a decline in fertility creates a favourable age structure, with a low rate of dependants to working-age people, helping to fuel economic growth. Within a few decades, however, the population begins to age.[35] In Indonesia, for example, the World Bank predicts that the dependency ratio will start to rise between 2020 and 2025[36], after which the task of escaping the middle-income trap becomes more difficult.[37]

TRENDS ON DEVELOPMENT COOPERATION WITH MICs

To assess how other bilateral donors approach development cooperation with MICs, the evaluation team examined the aid policies of Canada, Denmark, the Netherlands, Sweden and the United Kingdom's Department for International Development (DFID). Common themes emerged.

Canada, Denmark, the Netherlands and Sweden all use the language of 'partnership' to signal a maturing of aid relationships with MICs. Recognising that the primary purpose of aid to MICs is no longer to fill finance gaps, these countries are shifting towards knowledge-based assistance

32 Kharas at al, '*Financing the post 2015 Sustainable Development Goals: a rough road-map*', Overseas Development Institute, 2014.

33 *World Bank data.*

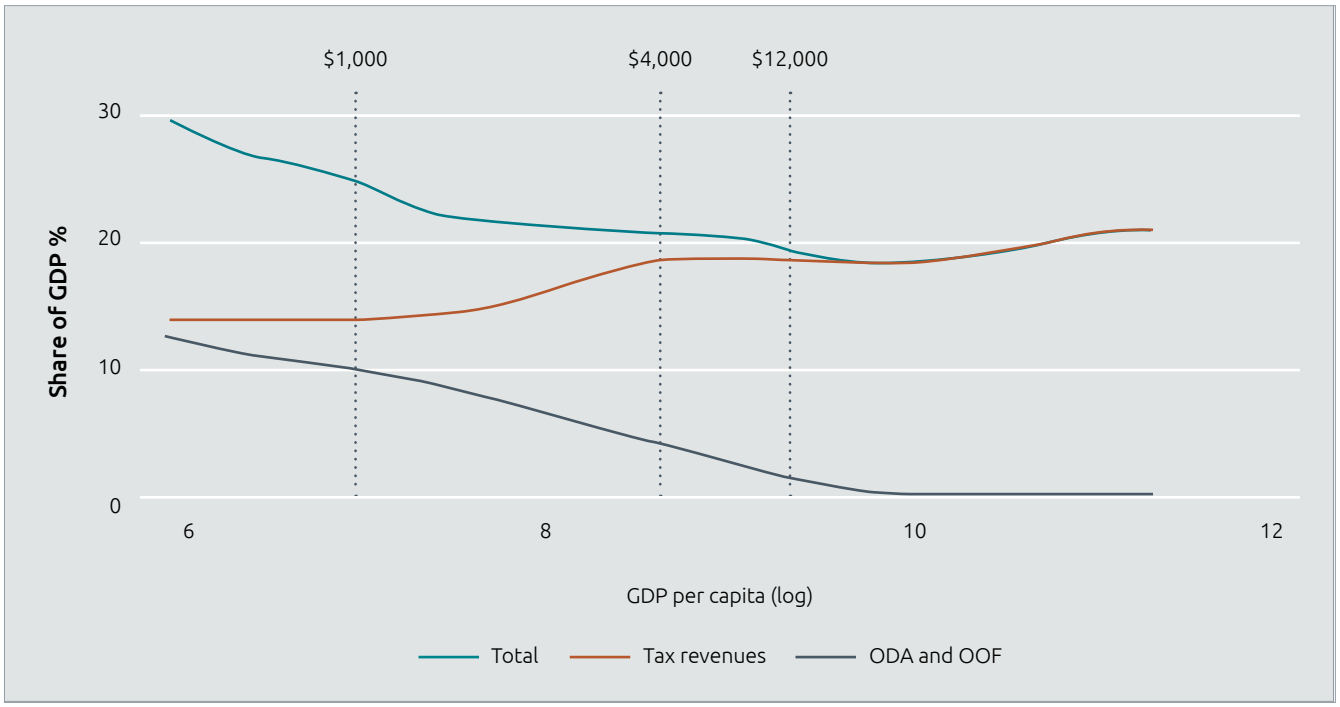
34 Raul Junquera-Varela et al., *Strengthening Domestic Resource Mobilization,* World Bank, 2017, p. ix.

35 Ronald Lee and Andrew Mason, '*What is the demographic dividend?*', *Finance and Development*, vol. 43, no. 3, 2006.

36 World Bank, *Indonesia 2014 and Beyond: A Selective Look*, 2009, p. 31.

37 Speech by former World Bank Managing Director Sri Mulyani Indrarwati, '*The transformation of the Indonesia economy in challenging times*', Columbia University, November 2015.

Figure 2: The 'missing middle' of development finance



Source: Kharas at al, '*Financing the post 2015 Sustainable Development Goals: a rough road-map*', Overseas Development Institute, 2014.

(that is, technical assistance and capacity building). The smaller European donors focus their partnerships in niche areas where they have a strong technical offer (for example, the Netherlands on water management, Norway on fisheries and Ireland on innovation policy). Partnership between government institutions is a common approach. There is also a change in the sectoral balance, away from social sectors and towards economic development. This includes direct support to the private sector, often in the form of loans and equity investments.

All five donors are concentrating their aid in low-income countries and fragile states and transitioning out of MICs, in whole or in part. Denmark, DFID, the Netherlands and Sweden have all exited from aid to Vietnam, although some ODA continues to flow there through regional instruments and multilateral channels. DFID has phased out most bilateral aid to China, India, Indonesia and South Africa since 2011, but United Kingdom aid continues to flow to MICs in the form of international climate finance, through the development finance institution CDC Group and through cross-government funds on prosperity and security issues.

Donor policies made no reference to middle-income traps or the development risks facing MICs. In the coming years, as more low-income countries reach MIC status, the proportion of the global poor living in MICs will increase. The Sustainable Development Goals will not be achieved without a significant acceleration of progress in MICs. The question of how development cooperation can support this has not been a focus of global development policy dialogue. However, the 2018 general capital increase for the World Bank comes with a commitment to increase lending to lower middle-income countries with the greatest financing needs.[38]

There is a limited literature on how donors manage exit or transition from bilateral aid. It suggests that the primary driver has been political pressures in donor countries. A report by the United Kingdom's Independent Commission for Aid Impact (ICAI)[39] found that such pressures had led to poorly planned and executed exits from both India and South Africa (Box 3). The lesson is an instructive one for Australia: If the case for continued aid to Asian MICs is not clearly articulated, there is a risk that political pressures on the aid program might lead to hasty exits and damage bilateral relationships.

38 World Bank Development Committee, *Forward Look: A Vision for the World Bank Group in 2030—Implementation Update*, March 2018.

39 ICAI, *When aid relationships change: DFID's approach to managing exit and transition in its development partnerships*, November 2016.

Box 3: DFID's challenges with managing transition

DFID's longest and arguably most successful development partnership was with India, where it enjoyed an unrivalled depth of relationships with institutions at national and state levels. It had also invested over many years in developing national civil society.

In 2012, following a sustained campaign in the United Kingdom press, DFID announced that it would end financial aid to India by 2015, while continuing technical assistance and capital investment. While the transition was agreed with central government counterparts, the objectives were not well communicated to national stakeholders, causing damage to relationships. A public communication plan agreed between the two governments was disregarded when United Kingdom officials made premature announcements. DFID also faced difficulties in communicating its ongoing work in India to the United Kingdom public, opening itself to additional criticism. Without DFID support, Indian civil society organisations experienced both a loss of funding and a loss of access to government. United Kingdom's ICAI found that these risks had not been properly identified or managed.

In contrast, ICAI found that, in Indonesia, DFID successfully transitioned to a relationship focused on climate change, while in Vietnam, its management of exit from aid was held up by the government as an example for other donors to follow.

Source: ICAI, *When aid relationships change: DFID's approach to managing exit and transition in its development partnerships*, November 2016.

With the exception of Canada, donors' rationale for aid to MICs includes strong elements of mutual benefit. The Netherlands, for example, states that the purpose of trade-related support for MICs is supporting growth and employment creation in both countries. The United Kingdom has moved the most decisively in this direction. One of the four objectives of the United Kingdom Aid Strategy is promoting global prosperity, to reduce poverty and strengthen trade and investment opportunities for the United Kingdom.[40] The United Kingdom Government has established a cross-government Prosperity Fund, under the authority of the National Security Council, with a budget of GBP1.2 billion over six years. Even as DFID phases out traditional aid, the Prosperity Fund is directing substantial ODA back into MICs, where commercial opportunities for United Kingdom firms are most likely to arise (Box 4). The Netherlands has also used aid to facilitate links between its own companies and companies in Asian MICs, although on a smaller scale. As yet, there is no firm evidence on the effectiveness of these new approaches and whether their pursuit of mutual benefit detracts from their primary objective of promoting development, which is the basis for their ODA eligibility.

40 HM Treasury and DFID, *UK aid: tackling global challenges in the national interest*, November 2015, p. 9.

Box 4: The United Kingdom Prosperity Fund

The Prosperity Fund is a cross-government fund with a budget of GBP1.2 billion (2016–17 to 2021–22) for promoting economic development and prosperity in developing countries. Its primary purpose is poverty reduction, but it also has an explicit 'secondary purpose' of creating opportunities for international business, including United Kingdom business. While its remit is global, it is focusing most of its resources on MICs, especially in Asia. It supports improvements to the business climate and competitiveness. It also supports the development of sectors where United Kingdom companies are judged to be competitive, such as clean energy, the financial sector and health services.

For example, in Thailand, the Prosperity Fund supported the development of the first Public Procurement Act. Approved in December 2016, the Act standardises public procurement practice and makes it more transparent. Through these reforms, the Prosperity Fund believes that United Kingdom and other international firms will have greater access to forthcoming tenders to expand mass transit systems and airports, opening up GBP1 billion in opportunities.

As the Prosperity Fund is still at an early stage, it is too early to assess its achievements against either its primary or secondary purpose.

Sources: ICAI, *The cross government Prosperity Fund: a rapid review*, February 2017; United Kingdom Government, *Prosperity Fund: Annual Report 2016/17*, December 2017.

KEY MESSAGES

- ODA is a declining share of the finance available to Asian MICs.
- Infrastructure finance has become an arena for competition for influence.
- MICs face difficult economic transitions, with real risks of stagnation and setbacks. Escaping the middle-income trap requires the development of more sophisticated institutions and policies.
- Other bilateral donors have moved towards a partnership model of assistance for MICs. This has involved shifting from traditional sector support towards knowledge-based assistance focused on promoting economic development.
- In most cases, the transition to a partnership model is a transitional step to phasing out bilateral assistance. There is little or no focus in aid policies on helping MICs through economic transitions, which is a potential blind spot in the global approach to implementing the Sustainable Development Goals.
- The pursuit of mutual economic benefit is emerging as a common objective of bilateral aid to MICs. However, the effectiveness of using aid programs to build trade and investment links remains untested.

3. THE EVOLUTION OF ECONOMIC PARTNERSHIPS

This chapter assesses how Australian aid is evolving to support economic partnerships in Indonesia and Vietnam. It looks first at changes taking place in the objectives and forms of Australian development assistance. It then explores the relevance of the economic partnership idea to the interests and priorities of Australia and the partner countries. Finally, it assesses options for improving the complementarity of aid, trade and economic diplomacy, and what risks and opportunities that might present.

THE EMERGING ELEMENTS OF ECONOMIC PARTNERSHIP

In both Indonesia and Vietnam, there has been an evolution in the form and objectives of Australian assistance, as country programs have responded to declining aid budgets, both absolutely and relative to other sources of development finance. This has been a rebalancing rather than a change of direction. While they predate the economic partnership concept and are not necessarily unique to Asian MICs, the elements described here were identified in discussions with DFAT posts and other stakeholders as most associated with economic partnership.

From bricks and mortar to knowledge-based assistance

In both Indonesia and Vietnam, there has been a marked shift in the balance of Australia's development cooperation, away from the direct financing of development results towards knowledge-based assistance that aims to promote policy change and institutional development and improve how partner countries use their own resources.

In Indonesia, this shift is visible in a number of sectors. In 2010, Australia announced an education program to build or expand 2,000 junior secondary schools.[41] The next iteration of the program focused instead on what happens within those classrooms, by influencing education policy and teaching practice.[42] Australia made substantial investments in building infrastructure over the past decade, including a AUD300 million loan for road building (Eastern Indonesia National Roads Improvement Project (EINRIP) 2005–16) and a AUD239 million fund to raise quality standards (Indonesia Infrastructure Initiative (IndII) 2007–17). As the Indonesia Government's own infrastructure investment has risen, the balance of Australian support has shifted from construction to technical and advisory support. A new AUD300 million program (Indonesia Australia Partnership for Infrastructure 2016–26) uses a facility model to support policy development and project management, with funding for construction mainly used for pilots.

DFAT Indonesia has also developed a number of programs that are solely or largely knowledge-based, including a:

- technical assistance facility on economic governance (Australia Indonesia Partnership for Economic Governance (AIPEG) AUD112 million; 2009–18)
- fund that supports partnerships between Australian and Indonesia government institutions (Government Partnership Fund Phase II (GPF) AUD118 million; 2011–17)[43]
- program to increase the access of Indonesian policy makers to research and analysis (the Knowledge Sector Initiative AUD64 million; 2012–22)
- facility that builds the capacity of the Indonesia Government to design and implement effective social protection programs (Towards a Strong and Prosperous Indonesia Society (MAHKOTA) AUD62 million; 2016–19).

41 DFAT, *Australia's Education Partnership with Indonesia*, Education Sector Support Program design document, Australian Government, October 2010.

42 Lisa Cornish, *Australian Aid's innovative approach to education in Indonesia,* devex, 16 November 2017.

43 AIPEG and GPF were merged into a single facility, the Australia Indonesia Partnership for Economic Development.

In Vietnam, Australia's flagship program in recent years has been the Cao Lanh Bridge (AUD160 million; 2011–18), which is DFAT's largest single investment in mainland Southeast Asia. As that project ends, the direction of travel is away from bricks and mortar towards a new generation of programs that are primarily knowledge-based, including a:

» new transport partnership designed to address weaknesses in project preparation and implementation, and to increase private infrastructure finance through public-private partnerships (Australia Vietnam Transport Development Partnership or Aus4Transport, AUD30 million; 2017–21)

» technical assistance facility that supports competition policy and the shift towards a market-based economy Restructuring for a More Competitive Vietnam (RCV) AUD3.6 million; 2014–17 and its successor program, Aus4Reform AUD6 million; 2017–21)

» partnership with the World Bank to support analytical and advisory work in key policy and reform areas (Australia-World Bank Strategic Partnership in Vietnam Phase 1, AUD30.5 million; 2012–16 and Phase 2, AUD25 million; 2016–21).

It would be wrong to overstate the novelty of knowledge-based assistance. It has always been important to Australian development cooperation. However, as the partner countries' need for ODA to fill financing gaps has decreased and as Australian aid budgets have declined, knowledge-based assistance has emerged as a central focus of Australian assistance.

Backing reformers

A distinctive feature of this change is a strategy of positioning Australia as a partner for economic and social policy reform. Using variations on the facility model, DFAT programs provide advice and technical support to help reformers and reform initiatives. Priorities are agreed with national counterparts, to increase ownership. The programs are designed with the flexibility to respond quickly to reform opportunities as they emerge, as well as to support longer-term change. The main economic governance facilities in the two countries—AIPEG and RCV—work in a politically informed manner to help national reformers achieve their objectives.

The evaluation team interviewed stakeholders from the central ministries responsible for development cooperation and a number of other counterpart agencies, as well as a selection of other development partners. When asked to identify the strengths of Australian aid, a significant number identified support for national reformers through flexible technical assistance. In Vietnam, the departure of most bilateral donors has left Australia in a useful position, not too large and not too small. In Indonesia, the combination of technical assistance facilities and World Bank trust funds gives Australia multiple points of support for economic and social policy making. In Indonesia, a senior official in the infrastructure sector described DFAT assistance as aligned with the government's priorities and useful in supporting evidence-based policies. Several Indonesian informants familiar with Australian aid noted that, while the MDBs have a comparative advantage in more technical subjects and in drawing on comparative international experience, Australian programs are adept at building relationships and tailoring their knowledge products to the political context.

Influencing other development finance

There is a strong focus on improving how governments maximise and use their own resources. In Indonesia, Australian advisers are helping to improve revenue raising capacity, introduce medium-term budget planning, align planning and budgeting systems, improve transfers to local government, replace wasteful subsidies with targeted social welfare measures, and pilot new models of infrastructure finance. In Vietnam, through the World Bank partnership, DFAT has supported the government to articulate its development policies (including through the *Vietnam 2035* study[44]) and convert these into budget priorities (including through a public expenditure review). These are challenging areas in which to achieve breakthroughs, but the development returns are potentially high.

Australia is also investing heavily in strengthening the capacity of the World Bank and Asian Development Bank. In Indonesia, Australia contributes to seven World Bank trust funds, with total funding of nearly AUD400 million (Table 2), although most funding was transferred during 2008–12 when the Indonesia program was scaling up. These trust funds have enabled the World Bank to build its Indonesia country office into the largest in the world, with a regular program of analytical work. MDBs in MICs have fewer resources to fund advisory work and project preparation, and the trust funds help to fill this gap.

Table 2: Australian support for World Bank trust funds in Indonesia

Sector	Trust fund	Funding (million AUD)	Duration
Economic governance	Support for Macroeconomic and Fiscal Policy Analysis	7.3	2012–20
Infrastructure	Indonesia Infrastructure Support	40	2008–19
Infrastructure	Water Supply and Sanitation for Low Income Communities	114	2008–21
Community development	Local Solutions to Poverty, formerly National Program for Community Empowerment Support Facility	191.5	2008–20
Social protection	Partnership for Knowledge Based Poverty Reduction	28.4	2010–19
Education	Improving Dimensions of Teaching, Education Management and Learning Environment	9	2016–19
Environmental governance	Sustainable Landscape Management Multi-Donor Trust Fund	5.2	2017–19

Source: Data provided by DFAT Indonesia Post.

44 World Bank Group and Ministry of Planning and Investment, *Vietnam 2035: Toward Prosperity, Creativity, Equity, and Democracy*, 2016.

In both countries, Australia is working with the government to improve the enabling environment for private business and to build government capacity to enter into public-private partnerships for infrastructure development. At the time of field work for this evaluation, there had been no significant shift towards supporting the private sector through development capital investment (loans, equity or guarantees). In November 2017, however, DFAT announced the establishment of a new AUD40 million Emerging Markets Impact Investment Fund, which will provide development capital investment for small-to-medium enterprises in South and Southeast Asia, with a focus on social impact.[45] There is ongoing debate on whether Australia should follow other bilateral donors and develop a more substantial development finance institution (Box 5).

Box 5: Is there a case for development capital investment in Asian MICs?

Unlike many other bilateral donors, Australia does not have its own development finance institution. There is debate within DFAT as to whether this would be a useful addition to Australia's economic partnerships. Some take the view that the ability to provide loans, equity investments and guarantees would enable Australia to achieve more impact with a constrained aid budget, including by leveraging private investment. The 2014 aid policy notes the importance of leveraging private sector resources, but also cautions that Australian aid 'will not subsidise business by financing activities that a business would otherwise have financed itself.'[46] This principle of 'additionality' is key to the development case for development finance institutions. They deliver impact by demonstrating that commercial returns are achievable in areas underserved by the market, thereby encouraging more private sector investment. Development finance institutions seek to invest in areas where private finance is scarce or not available at reasonable terms, often because the market overestimates the level of risk involved. Opportunities for additionality are more likely to arise in low-income countries and countries affected by political instability, than in Asian MICs with active financial systems. While there may be market failures—in particular, sectors or localities—detailed analysis would be required to establish whether there is a case for development capital investment in Asian MICs.

Source: Kingombe, C., Masse, I and te Velde, DW, '*Comparing development finance institutions: Literature review*', Overseas Development Institute, 2011.

Supporting regional cooperation and economic integration

The ASEAN and Mekong program, Australia's regional program in Southeast Asia, contributes to economic partnerships in three main ways:

- **Promoting regional economic integration:** Two regional investments are working with the ASEAN Secretariat towards implementation of the ASEAN Economic Community. According to a blueprint agreed by ASEAN leaders in 2015, the goal of the Economic Community is to ensure that ASEAN's 10-member states are economically integrated with each other and with the global economy. Australian support includes the development of regional strategies, norms and standards, research and policy advice, and capacity building of the ASEAN Secretariat. In addition, several regional investments support national activities to implement the Economic Community.
- **Improving connectivity:** DFAT has provided strategic support to ASEAN's connectivity agenda, by helping to develop the Master Plan on ASEAN Connectivity 2025 and funding a number of infrastructure-related projects. The Master Plan aims to increase regional connectivity and trade by improving infrastructure linkages, digital innovation, logistics, regulatory environments and people mobility. The ASEAN and Mekong program also works through subregional mechanisms, such as the Greater Mekong Subregion, to help countries streamline cross-border trade by supporting border infrastructure (including institutional or soft infrastructure related to customs).
- **Tackling cross-border challenges:** An economically integrated region needs the capacity to tackle cross-border challenges and promote regional public goods. DFAT's regional programs promote safe labour migration, both by building law enforcement capacity to tackle human trafficking and by promoting policy reform in support of regular migration. It also supports an initiative on regional health security, including animal health and cross-border trade.

These initiatives pre-date the economic partnership concept but share its objectives.

45 DFAT, *Emerging Markets Impact Investment Fund (EMIIF): Draft Design*, Australian Government, October 2017.

46 DFAT, *Australian aid: promoting prosperity, reducing poverty, enhancing stability*, Australian Government, June 2014, p. 11.

Building durable relationships with partners through mechanisms such as scholarships and short courses

A long-standing and high-profile feature of Australian aid has been its large program of scholarships to study in Australia. Within MICs, there is ongoing consideration of how best to capitalise on scholarships as a means of strengthening bilateral ties and building capacity in key institutions. With this is mind, there has been a move in recent times to increase the number of short course awards, to maximise the numbers of alumni with a connection to Australia (Box 6).

Box 6: Scholarships and economic partnerships

In Indonesia and Vietnam, there has been a shift towards using scholarships in a more targeted way, to build links with Australia at institutional and individual levels. This is not unique to economic partnerships but can help support their objectives. Scholarships are being directed towards institutions and sectors identified as important for building bilateral economic ties. There is a shift towards short-course awards, to maximise coverage. There is also more resource going into maintaining alumni networks, not just among scholarship recipients but also among private students (in 2018 there were more than 13,000 Indonesian students studying in Australia, but only around 900 were on aid-funded scholarships). For example, the Red Cattle Partnership places Indonesian farmers with Australian farmers for training, and then uses the alumni network to build linkages between the industries in both countries. Ongoing tracer studies will help to identify whether scholarships and awards build long-term bilateral ties.

Source: Information from DFAT posts.

KEY MESSAGES

The transition towards economic partnerships as an organising concept for Australian aid to Asian MICs is ongoing, but evident in the evolution of the objectives and methods of development cooperation, including:

- shifting towards knowledge-based assistance
- positioning the aid program to support key reformers and reform initiatives in a flexible way
- influencing how other sources of development finance are spent, including national budgets and MDB lending
- focusing on regional economic integration and cooperation
- emerging focus on building durable relationships and linkages with key partners and institutions through scholarships and courses.

HOW WELL DOES THE POSITIONING OF AID TO STRENGTHEN ECONOMIC PARTNERSHIPS REFLECT THE INTERESTS OF AUSTRALIA AND THE PARTNER COUNTRIES?

Alignment with partner country interests

In Indonesia and Vietnam, the evolution of the aid program to support economic partnerships is a good fit with national needs and priorities. This was evident in the use of aid to mobilise and make better use of domestic finance, support economic reform and promote regional integration.

Mobilising and making better use of domestic finance

Rebalancing Australian aid from direct financing of infrastructure and services towards supporting partners to raise the volume or quality of domestic expenditure makes good sense in both countries.

In Indonesia, the government has made infrastructure development central to its growth strategy.[47] World Bank analysis suggests that Indonesia needs to boost its infrastructure spending substantially to escape the middle-income trap before it loses its demographic advantage.[48] Indonesia's planned infrastructure investments of USD187 billion over 2015–19 are at an all-time high but are USD50 to 60 billion per year below what the World Bank says is needed to close the infrastructure gap.[49]

47 World Bank, *'Indonesia: Basing infrastructure investment on more solid ground'*, World Bank Feature story, 30 January 2017.

48 PwC, *Indonesian Infrastructure: Stable foundations for growth*, 2016, p. 5.

49 World Bank, *Project paper on Indonesia Infrastructure Finance Facility—Additional financing* March 2017, p. 7.

Given that scale of need, Australia's aid for infrastructure (around AUD60 million per year) does not make a material difference to the volume of infrastructure finance available to Indonesia. Its value lies in improving the quality of Indonesia's own infrastructure spending.

Indonesia also needs to increase its investment in human development, to tackle stunting, improve educational attainment and build the human capital required to raise productivity. Indonesia currently collects less than half of its potential tax take, and its tax revenue has been declining as a proportion of GDP.[50] To address this, Australia is supporting improvements to revenue collection, planning and budget systems, to raise the level and quality of national spending on public services.

Vietnam faces a different set of challenges around infrastructure investment. Its government has imposed a spending cap to keep public debt under control. A substantial pipeline of MDB-financed projects for strategic infrastructure is currently frozen. Australia's new Aus4Transport program will focus on project preparation, feasibility studies and procurement, trying to unlock the pipeline. In this context, carefully targeted grant finance can enable larger projects to reach implementation, addressing bottlenecks to Vietnam's economic growth. Vietnam also faces challenges with making effective use of its national development budget, with resources spread across too many projects (one study found that more than 20 airports, 24 deep-sea ports, 18 economic zones and 260 industrial parks were under construction[51]), with poor selection and design, low completion rates and inadequate expenditure on operations and maintenance. Against this background, the World Bank concludes that the priority is not to raise the overall level of public investment, but to improve its quality.[52] This is one objective of Australia's partnership with the World Bank in Vietnam.

Supporting economic reforms

Both countries recognise the need for economic reform. Vietnam is mid-way through the transition from a state-run to a market economy, but the pace of transition has slowed in recent years. While thousands of state-owned enterprises have been at least partially privatised, the state still exercises a virtual monopoly over strategic sectors such as banking, coal, construction, fertiliser, plastics and utilities. While Vietnam has done well at attracting foreign investment into light manufacturing, the dominance of the state inhibits the growth of Vietnam's own private sector. Total factor productivity, a measure of overall efficiency in the economy, has been in decline since the 1990s.[53]

The Vietnam Government is committed to completing the transition to a market-led economy[54], but is making slow progress in the face of political and bureaucratic constraints. It has identified competition law and policy as a tool for overcoming the dominance of state-owned enterprises and creating space for private sector development. Australia's economic governance facility, RCV, is supporting these efforts.

Indonesia is also pursuing reforms that are politically and technically challenging. Australia is offering support in many areas, including financial system regulation, public financial management, trade policy and social protection. Its programs are positioned to support reformers in government, including the Minister of Finance (a former senior World Bank official) and the National Team for the Acceleration of Poverty Reduction (on social protection). Feedback from Indonesia Government counterparts was that they value Australia's support in these areas, which combines quality technical advice with an appreciation of the political constraints on reform.

While Australia aligns its support to the efforts of national reformers, many reforms its supports face resistance from vested interests. Part of the alignment is therefore working to identify and strengthen constituencies for change.

Promoting regional economic integration

At the regional level, Australia has a long-term partnership with ASEAN to support implementation of the ASEAN Economic Community, under a Blueprint agreed by member countries in 2015. Through the ASEAN-Australia Development Cooperation Program Phase II (AUD57 million; 2008–19), Australia is helping to support the development of regional norms and standards and to build a better knowledge base for regional policy.

Elements of the regional economic integration agenda are politically challenging. While there has been progress on lowering tariffs, this has been accompanied by an increase in non-tariff barriers, and intra-ASEAN trade has not grown

50 Jim Yong Kim, '*Indonesia's future depends on its investments now*', World Bank article, 27 July 2017.

51 Marcus Cox & Tran Thi Hanh, *Development Finance for Sustainable Development Goals in Middle-Income Viet Nam*, UN, Multidimensional Poverty Index and European Union, December 2014, p. 24.

52 Viet Tuan Dinh et al., *Taking Stock: An update on Vietnam's recent economic developments*, World Bank, December 2017, pp. 36–39.

53 World Bank and Ministry of Planning and Investment, *Vietnam 2035: Towards Prosperity, Creativity, Equity, and Democracy*, 2016, p. 109.

54 Vietnam Government, *Master plan on economic restructuring,* 2013.

as a proportion of total ASEAN trade in the past decade.[55] Political economy analysis suggests a struggle between pro-liberalisation technocrats and political, bureaucratic and economic actors that defend the status quo.[56] Against that background, Australia is helping to support ASEAN as a forum for discussion, negotiation and incremental reform in niche areas, such as regulatory reform in financial technology and developing mutual recognition arrangements for agriculture and services.

Communicating around economic partnerships

The alignment of Australian aid behind economic partnerships is a good fit to the needs and interests of Indonesia and Vietnam, but DFAT could do better at explaining what it means by the term to national counterparts in both countries. In Vietnam, while welcoming Australia's development cooperation and the idea of a mature partnership of equals, senior officials from the Ministry of Planning and Investment and the Ministry of Finance, which oversee development cooperation, expressed uncertainty about what economic partnership meant in practical terms. One official from BAPPENAS One official from BAPPENAS, Indonesia's Ministry of National Development Planning, understood economic partnership as aid offered in support of the Indonesia-Australia Comprehensive Economic Partnership Agreement, which is under negotiation.

Alignment with Australia's interests

Australia has strong interests in building successful economic partnerships with Asian MICs.

Australia's economic and security interests are closely tied to the growth of prosperity in the region. Taken together, ASEAN has a population larger than the European Union or North America, and a USD2.5 trillion GDP—on a par with major trading partners such as the United Kingdom. Australia's *2017 Foreign Policy White Paper* refers to estimates that Asia, as-a-whole, could be home to a middle class of almost 3.5 billion by 2030, stimulating demand for Australian minerals and energy, services and premium agriculture products.[57] As export destinations, Indonesia and Vietnam currently rank 11 and 13 respectively[58], and have the potential to become much more important markets for Australian goods and services. However, their continued growth through the challenging transitions ahead is not guaranteed.

A closely related point is the Australian interest in regional stability and security. ASEAN is in a strategic position in major global trade routes. Greater economic integration would help counterbalance the risks posed by geo-economic rivalry. Australia also has an interest in protecting stability within neighbouring countries, especially Indonesia. Rising inequality has the potential to threaten democracy and social stability, with potential links to irregular migration. This may become a more urgent concern over the coming decade, if more Asian countries see their economic growth plateau and inequality rise.

> **INDONESIA IS A DYNAMIC, DEMOCRATIC, DIVERSE AND GROWING G20 MEMBER … INDONESIA'S SUCCESS IS OF FUNDAMENTAL IMPORTANCE TO AUSTRALIA … THE SIZE, WEIGHT AND LOCATION OF INDONESIA AT THE INTERSECTION OF THE INDIAN AND PACIFIC OCEANS MAKES IT A LEADER IN OUR REGION, INCLUDING IN ASEAN.**
>
> —2017 Foreign Policy White Paper

Given these interests, there is a strong strategic case for continuing development cooperation with Asian MICs, to support regional growth and stability. Economic partnership has emerged as a way of communicating that case. Several DFAT stakeholders, including at senior management level, expressed the view that a purely altruistic case for continued aid, based on the numbers of poor people in Asian countries, is no longer enough to ensure political and public support. There is a risk that, if the Australian interest is not clearly articulated, political opposition to providing aid to Asian MICs might lead to a sudden decision to exit. The economic partnership framing emphasises the building of bilateral economic ties, for mutual benefit. However, DFAT stakeholders both in Canberra and in the two countries agreed that this case needs to be made more explicitly and assertively for Australian policy makers. Potentially, the case could also be made for re-establishing development cooperation, in modest and targeted ways, with countries from which the aid program has already exited, such as Thailand, which are yet to make the transition to higher income status.

55 Jorn Dosch, '*The ASEAN Economic Community: What Stands in the Way?*', East-West Center, *Asia Pacific Issues,* no. 119, September 2015.

56 Lee Jones, 'Explaining the Failure of the ASEAN Economic Community: The Primacy of Domestic Political Economy', *The Pacific Review,* vol. 29, no. 5, March 2015.

57 DFAT, *2017 Foreign Policy White Paper,* November 2017, p. 28. The estimates of the Asian middle class come from the Brookings Institution.

58 DFAT, '*Australia's trade in goods and services 2016*', Australian Government.

The *2017 Foreign Policy White Paper* emphasises that trade, investment and infrastructure finance are arenas for geo-economic competition in the region. Against this background, economic partnerships offer Australia the potential to maintain influence with key counterparts in Asian MICs, despite a declining aid budget. If Australia continues to build its comparative advantage in knowledge-based assistance to help national leaders deliver complex economic and social reforms, it will help to distinguish Australia's offer from others' and build partnerships with key stakeholders.

The work in the infrastructure sector has particular relevance, given the risks of partner countries taking on Chinese loans that prove uneconomic, compromising their debt sustainability. Given its modest scale, direct Australian finance for infrastructure development will not of itself reduce reliance on other sources of finance. However, Australia's knowledge-based assistance can help partner countries become more informed customers for infrastructure finance, better able to calculate the true costs and benefits of proposed investments.

KEY MESSAGES

- Key stakeholders in the case study countries acknowledge the value of Australia's knowledge-based assistance for policy reform.
- Australian aid makes only a modest difference to overall levels of development finance but can help partner countries mobilise other resources and improve the quality of their investments and public spending.
- Economic partnerships promote the long-term Australian interest in regional prosperity and stability, open economies and improved business environments.
- There is a need to strengthen the narrative around economic partnerships, for both national counterparts and Australian stakeholders.

SCOPE FOR IMPROVING THE COMPLEMENTARITY OF AID, DIPLOMATIC AND TRADE INITIATIVES TO STRENGTHEN ECONOMIC PARTNERSHIPS

This section considers what scope there is for greater alignment of development cooperation with diplomatic and trade initiatives in support of economic partnership, and the risks and opportunities involved in pursuing it.

Development cooperation and diplomatic engagement

There is a natural complementary between development cooperation and diplomacy that is well recognised within DFAT. Departmental officials at posts valued the opportunities that aid programs offer for diplomatic engagement, by providing access to institutions and decision-makers, generating knowledge of policy issues and processes, and contributing to Australia's profile and reputation.

The shift towards knowledge-based assistance results in fewer branding opportunities around physical outputs. However, in Indonesia and Vietnam, this is creating new opportunities around high-profile events and publications. For example, the Indonesia Economic Quarterly (a World Bank publication funded by DFAT) offers a regular cycle of events with Indonesian policy makers, while the inaugural Indonesia Development Forum in 2017 (supported through DFAT's Knowledge Sector Initiative program) attracted 10 government ministers and extensive newspaper coverage. In Vietnam, the *Vietnam 2035* report[59] (a high-profile report on Vietnam's development, produced jointly by the World Bank and the Vietnam Government, with DFAT co-funding) provided an opportunity for the Ambassador to join the World Bank in discussions with the Vietnamese Prime Minister.

There are some tensions between the requirements of bilateral diplomacy and development cooperation. Diplomatic engagement typically cuts across a wide range of issues. It requires a high level of responsiveness to needs and opportunities that can be difficult to predict. It also requires investment in relationships that can be used for that purpose. A high value is placed on building Australia's profile and reputation, including through public diplomacy. This may not be directed towards any specific influencing outcomes in the short term, but rather at building up a stock of good will to facilitate future engagement.

59 World Bank Group and Ministry of Planning and Investment, *Vietnam 2035: Toward Prosperity, Creativity, Equity, and Democracy*, 2016.

For development cooperation, the focus is on achieving longer-term outcomes, such as policy changes or institutional reforms. It involves investing in deep relationships with selected institutions or decision-makers, to support their objectives, often working through intermediaries who bring their own networks and relationships. Given political sensitivities around external influence on government policy making, aid programs often work behind the scenes and avoid claiming credit for reform outcomes where that would be unhelpful.

The evaluation found that this tension was understood and was being navigated successfully in Indonesia and Vietnam. Branding requirements on knowledge-based assistance are modest and appropriate, and aid programs are not asked to pursue specific Australian interests where this would be unhelpful to their objectives.

There is scope for DFAT to pursue common influencing objectives across its diplomatic engagements and development cooperation. This is beginning to occur in both countries. In Indonesia, DFAT has identified a number of key messages on policy issues, such as the need to improve revenue collection, tackle inequality and liberalise markets to achieve lower and more stable food prices. These messages are being conveyed at various levels, including in public speeches by senior DFAT officials. In Vietnam, DFAT has begun to identify key policy objectives for each of its areas of engagement and to build these into advocacy strategies. For example, there is an objective around promoting gender equality within the Vietnamese labour code. The next step might be to set down an explicit set of influencing objectives for each economic partnership, with target audiences identified (for example, senior government officials, parliamentarians and journalists), and ensure that these messages are pursued consistently across development programs and diplomatic engagements.

The evaluation team noted efforts in both countries to reorient the scholarship program to maximise relationships and linkages in support of economic partnership. This includes a rebalancing towards short-term training and fellowships, which increases the number of alumni. It is not within the scope of this evaluation to judge the relative effectiveness and value-for-money of different award types, from either the diplomatic or development standpoint. This should be the subject of a separate and robust evaluation.

Development cooperation and trade

DFAT has made significant efforts in recent years to align its aid and trade work, including a commitment to spending 20 per cent of the aid program on 'aid for trade'.[60] The OECD Development Assistance Committee peer review noted that Australia is a global advocate for trade liberalisation, with a focus on the benefits for developing countries.[61] Its own trade policies are development-friendly: it offers duty-free, quota-free access to imports from least developed countries and maintains low agricultural subsidy rates and barriers for trade in services. This places it in the top 10 countries for trade on the Centre for Global Development's Commitment to Development Index.[62] Through the Australian Global Trade Integration Facility (AUD60 million; 2014–18), it funds multi-country projects that enable developing countries to make better use of their trading opportunities. DFAT also has regional projects that help ASEAN countries take advantage of the trading opportunities created by the ASEAN Australia New Zealand Free Trade Area (AANZFTA), promote implementation of the ASEAN Economic Community and develop hard and soft infrastructure for greater connectivity in the Greater Mekong sub-region. As well as supporting longer-term measures in regulatory reform and infrastructure connectivity, its projects focus on helping target groups (such as women entrepreneurs and small businesses) participate in trade, to demonstrate to developing countries that open trade can contribute to inclusive growth.

DFAT's trade facilitation programs were recognised in a 2016 were recognised in a 2016 Office of Development Effectiveness (ODE) evaluation as effective in addressing capacity gaps across a range of areas, with the potential to contribute to wider development results.[63] However, the evaluation also found minimal interaction between regional and bilateral programs on aid for trade.

Interviews with DFAT staff in Canberra and at posts suggests this remains the case. So far, the development of economic partnerships in Indonesia and Vietnam has not included a more ambitious approach to aligning development cooperation with trade objectives. However, there is discussion of using bilateral aid to support the implementation of the Indonesia-Australia Comprehensive Economic Partnership Agreement in Indonesia and the Trans-Pacific Partnership in Vietnam (Box 7). Free trade agreements create rights of market access for exporters on both sides. However, where the other party is a developing

60 DFAT, *Strategy for Australia's Aid for Trade Investments,* Australian Government, July 2015. Under OECD statistical classifications, 'aid for trade' encompasses support for trade policy and regulations, economic infrastructure and building productive capacity.

61 OECD Development Assistance Committee, *OECD Development Co-operation Peer Reviews—Australia*, 2018, p. 32.

62 Center for Global Development, *The Commitment to Development Index 2017.*

63 ODE, *Gearing up for Trade: Australia's support for trade facilitation programs*, Australian Government, April 2016.

country, it may not be able to take advantage of this access due to a lack of support regulations (such as mutual recognition of standards, fair competition policies and protection of intellectual property rights) and supply-side constraints in different sectors (such as an inability to meet phytosanitary standards). It is possible for bilateral free trade agreements to include economic cooperation chapters that address such issues, supported by capacity building or other assistance from the aid program. This would require country-specific analysis of the barriers for trade and support that is tailored to each country context, whether from bilateral or regional programs.

Box 7: DFAT support to Vietnam on the Comprehensive and Progressive Agreement for Trans-Pacific Partnership

In the lead up to a Trans-Pacific Partnership Ministerial Meeting in Da Nang, Vietnam, November 2017, Australia worked with Japan in a diplomatic initiative to encourage the Vietnam Government to join the 11-party trade agreement, following withdrawal by the United States. Using DFAT funds, the World Bank conducted a modelling exercise on behalf of the Vietnam Government to assess the benefits of joining for the Vietnamese economy. The analysis proved to be a key piece of evidence for the decision to join. Though funded from a DFAT trust fund, it was important that the analysis came from the World Bank, which was seen as having no vested interest in the outcome. DFAT is now considering providing support to Vietnam for the implementation of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership.

Source: DFAT Vietnam Post.

With few exceptions, DFAT is not using the aid program to pursue immediate trade or commercial advantage for Australia, beyond the long-term interest in improved business environments and more open economies. DFAT staff and program implementers agreed that aid programs should not be asked to do so, to avoid compromising their effectiveness. In Indonesia, DFAT has ensured that AIPEG keeps its advisory support on trade policy separate from ongoing Indonesia-Australia Comprehensive Economic Partnership Agreement negotiations, to avoid conflicts of interest.

This stance draws support from DFAT's experience with the Red Meat and Cattle Partnership (AUD43 million; 2012–24) in Indonesia, the only program in this evaluation with explicit objectives around increasing bilateral trade. It is a joint program between DFAT and the Department of Agriculture and Water Resources, launched following the resumption of live cattle exports to Indonesia. Industry representatives from Australia and Indonesia are involved. Implementation has proved challenging. While the channels for dialogue have been kept open, which is an achievement itself, progress towards the objectives has been limited. Not enough was done at the outset to test whether there was a committed counterpart and enough common interest for an effective program. While it is important to be wary of generalising from a single example, the experience suggests that there are pitfalls involved in deploying aid programs in trade-related areas where bilateral interests are not aligned.

However, there may be further scope for using aid to support bilateral trading without compromising the quality of development assistance, by focusing on sectors or areas where the economic interests of the two countries are complementary, rather than in competition. One possible area that emerged from discussions with government and business stakeholders in Indonesia, including with BAPPENAS, is vocational training. The Indonesia Government has a policy of raising the quality of vocational training to regional standards, so that Indonesian workers can access regional labour markets. This matches a DFAT regional priority. DFAT supports safe, legal migration as a way of combatting human trafficking and irregular migration. Through its AANZFTA support, DFAT also supports mutual recognition of education and training standards across ASEAN, as a step towards an eventual ASEAN skills recognition framework. Indonesia could be an important market for Australian education and training providers, but it limits access to the sector for foreign companies. Support through the aid program to vocational training could therefore support Indonesia Government priorities and an Australian trading interest.

Tourism was also mentioned as offering potential for mutual benefit. By helping Indonesia expand its tourism infrastructure (the 'ten New Balis' plan), Australia could support inclusive growth in Indonesia and provide opportunities for Australia companies in an expanding sector.

While there may be potential for increased synergy between aid and trade in such areas, it will remain essential to observe the principles of good aid practice. Poorly designed aid programs are unlikely to achieve good development results or trade benefits to Australia. The principles include:

- Compliance with the international ODA definition—development benefit to the partner country must remain the primary purpose of the assistance, while the benefits to Australia should be an indirect or secondary result of achieving the primary purpose.
- Commonality of interest—economic benefits should be recognised by both sides as mutual, rather than in competition.
- Transparency—potential benefits to Australia should be openly acknowledged.
- Alignment and country leadership—initiative should be aligned with national policies, or at least with a reform constituency.

KEY MESSAGES

- As Australia shifts from bricks and mortar aid projects, knowledge-based assistance can provide high-profile opportunities for diplomatic engagement.
- DFAT could be more explicit about its influencing objectives for each economic partnership and pursue them more consistently across its aid programs and diplomatic engagements.
- While Australia is a vocal advocate for inclusive trade, there has been limited progress on aligning bilateral aid programs with trade objectives.
- DFAT is appropriately cautious in using aid to support bilateral trade, to avoid compromising the effectiveness of aid. However, there is scope to use aid programs to support the implementation of economic cooperation provisions in bilateral and regional free trade agreements. There are also opportunities to develop sectors with the potential for greater bilateral trade, provided that the aid effectiveness principles are respected.

4. APPROACHES TO ECONOMIC PARTNERSHIP

This chapter explores the potential of aid programs in economic partnerships to contribute to the goals of supporting policy and institutional reform and leveraging other development finance. From the programs identified as most associated with economic partnership, the evaluation team survey the most significant results and explores what approaches have proved effective, based on lessons identified in program documents and by DFAT staff, implementers and counterparts. Finally, the evaluation team considers how well DFAT's systems and capacities facilitate its economic partnerships.

WHAT TYPES OF RESULTS IS AUSTRALIAN AID ACHIEVING WITHIN ECONOMIC PARTNERSHIPS?

From the programs that are most characteristic of how Australian aid is evolving within economic partnerships, the evaluation team identified some of the most important emerging results, particularly those involving policy outcomes, institutional reform and leverage of other development finance. The results were reported in program documents and identified in interviews with DFAT staff, implementers and counterparts. The analysis focused on identifying the types of results beginning to emerge within economic partnerships, rather than assessing the overall effectiveness of the programs in question.

As these are complex reforms with many actors, attribution to an external actor is difficult, but these are all areas where there is evidence that Australia has contributed to facilitating change or has good prospects of doing so.

» Social protection in Indonesia: The MAHKOTA program (AUD62 million; 2016–19) aims to build government capacity to provide an effective social safety net. It builds on a previous program, the Poverty Reduction Support Facility that operated from 2010 to 2015. Both programs supported an internal think tank on social policy, the National Team for Accelerating Poverty Reduction (TNP2K), located within the Vice President's office with around 60 staff members. TNP2K developed a unified household database of the poorest 40 per cent of Indonesian households, enabling a shift towards targeted social assistance programs based on means testing. It also supported the design, monitoring and evaluation of a number of Indonesia's major social programs, including rice distribution, free health insurance for the poor and cash transfers. The development of these programs enabled a reduction in untargeted electricity subsidies, with savings to the Indonesian budget of an estimated AUD1.6 billion in 2017.[64] Through this complex policy reform process, DFAT programs were instrumental in building and sustaining political support for these reforms, including by preparing evidence for parliamentarians and the media that the new social programs protected the poor from the impact of subsidy reform. Given that inequality has become a significant constraint on Indonesia's growth and risks becoming a source of social instability, these reforms are highly significant.

» Financial stability in Indonesia: The AIPEG program (with its predecessors) has facilitated a series of reforms to the management of Indonesia's financial markets, including improved banking supervision and financial market surveillance. A law on financial crisis management, passed in 2016, assigns responsibilities to Indonesian institutions for preventing and handling financial crises. AIPEG helped establish Indonesia's Financial Services Authority, which regulates and supervises the financial system. The Authority has also established an effective partnership with the Australian Prudential Regulation Authority. Given Indonesia suffered a collapse of its currency and a 14 per cent drop in GDP[65] in 1997 financial crisis, the strategic significance of this work is substantial.

64 DFAT, *Aid Program Performance Report 2016–17—Indonesia*, Australian Government, September 2017, p. 2.

65 Tulus Tambunan, '*The Indonesian Experience with Two Big Economic Crises*', *Modern Economy*, 2010, vol. 1, pp. 156–167.

» Improved public expenditure in Indonesia: Through many years of support, Australia has helped to introduce medium-term expenditure planning and improve alignment of planning and budgeting systems. Australia has helped to introduce performance-based grants from central to local governments and new methods of financing local infrastructure, raising the quality of local development expenditure. This has included working with the World Bank to pilot new ways of financing local development projects. In the context of Indonesia's 'big bang' decentralisation, which shifted responsibility for a large share of development expenditure to sub-national authorities where capacity is lower, this is a strategic area of work. DFAT estimated that, in 2016–17, AUD3.2 billion in additional investment (national expenditure and MDB loans) was committed to programs designed or piloted by Australia.[66] The figure suggests that Australia has been effective in piloting economic and social reforms, and that potential benefits of leveraging domestic expenditure far outweigh the direct financing effects of Australian aid.

» Economic restructuring in Vietnam: The RCV program works with the government on its Master Plan on Economic Restructuring. It has supported the development of a new Competition Law, to be adopted in 2018. It will increase the autonomy of the National Competition Authority, which will be a tool for reducing the dominance of state-owned enterprise monopolies and enabling the private sector to compete on fairer terms. This has the potential to reinvigorate Vietnam's process of economic restructuring. While it will be some years before the significance of the achievement can be assessed, stakeholders in Vietnam, including a number of current and former government officials, informed the evaluation team that the initiative has strong political backing and reasonable prospects of success.

DFAT Indonesia has adapted its Performance Assessment Framework to capture the results of its efforts to support policy reform within its economic partnership by tracking significant policy changes and improvements to Indonesia's own development spend. For 2016–17, 20 significant policy changes were reported (Table 3).

Table 3: Significant policy changes reported in Indonesia, 2016–17

Sector	No.	Examples
Efficient markets and financial systems	1	A new regulation on FinTech, facilitating access to finance through the expansion of digital financial services, including peer-to-peer lending.
Public finance	4	Introduction of medium-term budgeting, including a shift from cash to accrual accounting methods, to smooth expenditure across financial years and facilitate management of multi-year projects. Introduction of a new information technology application to support budget preparation, which helped the Ministry of Health identify about AUD100 million in savings. Improved resource allocation at village level, encouraging greater community participation in decision-making.
Human development	12	Elimination of electricity subsides to non-poor households, saving the government AUD1.6 billion in 2017. Expansion of the government's cash transfer program, from 3.5 million to 6 million households, with plans to add a further 10 million, providing a social safety net to tackle poverty and inequality. The introduction of a performance management system for school teachers, with incentive payments.
Inclusive development	3	Revised formulas for fiscal transfer from national to local governments to reward high-performing districts with additional funding.

Source: Data provided by DFAT Indonesia.

66 DFAT, *Aid Program Performance Report 2016–17—Indonesia*, Australian Government, September 2017, p. 24.

While some of these results are genuinely impressive, it is important not to overstate the level of influence that can be achieved, and in the event of successes, how much of this can be reasonably attributed to donor efforts. Programs seeking to support policy change must work with local reformers, which means that when they encounter success, it cannot be attributed solely to external support. It is also worth keeping in mind that in areas where there are no local constituencies to work with, there is little prospect of any reform taking place, even if the development case for it is well made.

This raises a question about how DFAT can best use the aid program to pursue objectives that are close to its values, but where there is no shared understanding with national stakeholders of the objectives or how to achieve them. This was evident in Vietnam, when DFAT promoted an approach on gender equality that had difficulty securing approval to proceed because of concerns within the Vietnam Government about its relevance and likely effectiveness (Box 8). While there will always be a balance to be struck between pursuing Australian cross-cutting objectives and aligning with partner preferences, as economic partnerships mature, it is likely that Australia will pursue such objectives in a manner that is more responsive to the expressed needs and priorities of partners.

KEY MESSAGES

» By providing evidence-based inputs to support local reforms and political coalitions, Australian aid is at times able to achieve some highly significant results. However, policy and institutional reform are subject to factors beyond Australia's control and are never guaranteed.

» There are examples where using Australian aid to pilot economic and social reforms has leveraged far larger investments from the MDBs and national budgets.

What approaches have proved effective?

This section considers the approaches used by the aid program to support policy and institutional reform and leverage other development finance. It also summarises lessons from program documents and stakeholders about ways of working that have proved effective.

DFAT's experience across the two countries suggests that no single approach is best suited for delivering knowledge-based assistance. The Indonesia program uses a range of approaches, enabling it to engage in multiple policy areas in different ways. The smaller Vietnam portfolio is more selective.

Box 8: Gender equality and economic partnerships

Vietnam Government stakeholders raised concerns with the evaluation team about a new DFAT program, AUS4Equality, which targets ethnic minority women. While recognising that Australia's investment on gender equality was a priority for Australia, they suggested the program was not a response to Vietnam Government priorities and therefore inconsistent with an economic partnership.

While this program was not part of the evaluation sample, the feedback raises the question of how to reconcile Australia's cross-cutting policy priorities with economic partnerships, especially where they are inconsistent with stated partner objectives. As its economic partnerships mature, Australia may need to adapt its methods for identifying investment priorities so they fit more comfortably within a partner-led paradigm. Rather than going back to direct delivery of results, Australia should work with and through domestic reform champions, through research, advocacy and coalition building. Integrating gender equality and other cross-cutting objectives into wider economic governance programs, while giving them licence to pursue them in contextually appropriate ways, would offer greater prospect of success.

Source: Key stakeholder interviews in Vietnam.

Economic governance facilities

Economic governance facilities (Box 9 for examples) enable DFAT to deploy technical assistance to support economic or social policy reform, making them well suited to supporting economic partnerships. This model permits flexible use of funds, within an overarching set of objectives. Activities can be planned on an annual basis, and funds set aside for reacting quickly to requests for support or short-term opportunities.

The three facilities described in Box 9 were all identified by stakeholders, both in DFAT and counterpart institutions, and through DFAT Aid Quality Checks as being effective at providing analysis and technical advice in a flexible and politically informed manner to support policy and institutional reform. Only AIPEG had undergone an external evaluation. It found that the facility 'acted as a trusted adviser to the Indonesia Government and contributed to policy in significant areas', supporting Indonesia's moves towards a more open trade and investment regime and improving financial supervision and crisis management.[67]

It was suggested that these factors contributed to the areas where programs had been successful:

- **Well-positioned:** The three facilities support institutions with clear reform mandates and identify and work with high-level champions. They also can work across government to link different institutions in support of reform. They recruit individuals with established networks across government (for example, the Team Leader of AIPEG is a former International Monetary Fund representative in Indonesia). They establish advisory groups, involving former politicians or senior technocrats, who can help bring issues to the attention of senior leaders. This strategy of buying in connections has proved effective at securing access to decision-makers.
- **Flexible and patient:** The facilities are long-term engagements, lasting a decade or more in some cases through successive iterations. This enables the programs to identify the most appropriate counterparts and to build relationships of trust. They can scale activities up or down as needed and be ready with evidence and analysis to support reform opportunities as they emerge.

Box 9: Economic governance facilities

AIPEG (AUD112 million; 2009–18). This is the fourth in a series of technical assistance facilities first established in 1999 to help Indonesia recover from the Asian financial crisis. It works in five areas—efficient markets, finance stability, revenue mobilisation, improved public spending, and economic policy. It also has resources for new or emerging issues, if warranted. It combines in-house expertise with the ability to engage short-term experts as required. It supports Tim Asistensi, the Assistance Team, which is a group of Indonesian economists providing economic policy advice to the government, working at arm's length from AIPEG. It partners with eight ministries and agencies and has undertaken more than 300 activities.

RCV (AUD3.6 million; 2014–17). This was established to support the Vietnam Government's Master Plan on Economic Restructuring. It works in three areas—increased business competition, stronger competition institutions, and restructuring the rural economy. It is a flexible fund that can respond to emerging issues. Its counterparts include the Vietnam Competition Authority and the Institute for Policy and Strategy in Agriculture and Rural Development. It partners with the Central Institute for Economic Management, a government-affiliated economic think tank. The Productivity Commission and the Australian Competition and Consumer Commission provide peer support. Its objectives include improvements in Vietnam's Global Competitiveness Index score, its labour productivity growth and its Corruption Perceptions Index score.

MAHKOTA (AUD 62 million; 2016–19). This is a variation on the model, which involves DFAT funding the Vice President's National Team for Accelerating Poverty Reduction, a team of Indonesian experts acting as an in-house government think tank on social policy. Australian support funds salaries and the development of a unified database to support the targeting of social protection.

Source: Program documents.

67 AIPEG, *Evaluating AIPEG 2009–2017: Summary Report,* August 2017.

- **Low profile:** Conscious of the sensitivities of counterpart institutions about accepting external support on key economic and social policies, the programs keep a low profile. While they contribute to Australia's profile and reputation within the counterpart institutions, they do not seek wider recognition.
- **Technically sound and politically informed:** To be effective in supporting reform, the advice provided by economic facilities needs to be not just technically sound but tailored to the political and institutional context. This involves assembling the right arguments and evidence, and presenting this to the right people at the right time. These facilities help to overcome constraints on counterpart institutions imposed by government procurement rules in engaging international experts.
- **Support both policy making and implementation:** he adoption of new policies or laws may be only the first step in a long road of implementation that is equally if not more challenging. The economic facilities use problem-solving approaches to identify and address bottlenecks as they arise.

The facility model has limitations. There were complex programs to establish, and there was a lengthy time lag before AIPEG and the Knowledge Sector Initiative (Box 10) were effective. While bringing in managers with established reputations and networks facilitates policy engagement, it can make it more difficult to keep the facility aligned with Australia's objectives. While facilities need flexible resources to respond to opportunities as they emerge, they also need careful management to ensure such resources are used strategically. The AIPEG evaluation observes that, while the program is sometimes able to catalyse change, it lacks the same degree of control over outcomes as other programs. Also, its initiatives can be stymied by a lack of support or capacity within the bureaucracy. Because it works with national reformers, some areas are unlikely to achieve success. For example, DFAT asked AIPEG to assess the possibility of working in the mining sector, but it found unfavourable political conditions.

Technical assistance facilities are less likely to be effective if they default to a train-and-equip approach. For example, AIPEG's work with the tax administration over a four-year period to 2015 produced 'disappointing yields', owing to 'deep-seated internal resistance to change'.[68] The assistance was mainly in the form of coaching, mentoring and provision of specialist equipment, without paying sufficient attention to likely mechanisms for change.[69] From 2016, the program shifted focus to working with a newly formed Tax Reform Team in the Ministry of Finance.

Box 10: Supporting evidence-based policy making

Indonesia's Knowledge Sector Initiative (AUD64 million; 2012–22) seeks to improve the country's systems for evidence-based policy making. It engages across the knowledge sector. It provides core funding to 16 Indonesian research institutes and think tanks to generate new knowledge and works with media institutes and advocacy organisations on the communication of research results. It also supports research units within government departments. The initiative works with BAPPENAS, on knowledge management and how to communicate good development practice to subnational government. It also helped to develop and pilot an e-planning tool that assists BAPPENAS to better target funding for priority development programs. In 2017, the initiative helped to organise the inaugural Indonesia Development Forum, which 10 government ministers attended, creating high-profile opportunities for public diplomacy.

The program identified the Indonesia Government's inability, under its own procurement regulations, to commission research and analysis from think tanks and universities as a key constraint on evidence-based policy making. A successful advocacy effort to secure change to the regulations was therefore a key breakthrough. However, given the breadth of the knowledge sector, the program struggled in its early years to articulate a clear strategy, secure buy-in from key stakeholders and develop methods of measuring progress. Program reviews have concluded that it has made progress in addressing those challenges and is now better placed to achieve its objectives. However, the value of investing in the knowledge sector as-a-whole, as opposed to focused knowledge inputs into specific policy areas, remains to be demonstrated.

Source: Knowledge Sector Initiative Aid Quality Checks 2015–17 and key stakeholder interviews.

68 AIPEG, *Evaluating AIPEG 2009-2017—Part B: The Case Studies*, June 2017, p. 66 (unpublished).

69 AIPEG management interviews.

A variation on the technical assistance model is also used at the regional level, to support ASEAN to develop and implement regional economic integration measures. The ASEAN-Australia Development Cooperation Program Phase II (AUD62 million; 2007–19) supports ASEAN with the design and implementation of region-wide initiatives such as consumer protection frameworks and mutual recognition of standards. It also responds to requests for technical assistance from ASEAN member countries. It provides short-term technical inputs to national initiatives to implement the ASEAN Economic Community. However, the impact has been held back by a lack of political support in member countries for regional initiatives. Technical assistance facilities at the regional level are also not as well placed to build long-term relationships with national reformers and to shape their work to the national political context. Finally, ASEAN lacks effective mechanisms to drive progress at the national level, making it difficult to identify impact from the program's analytical work. DFAT stakeholders in Canberra and the two case study countries also identified a lack of coordination between regional and bilateral programs on trade facilitation as a constraint on effectiveness.

Peer-to-peer partnerships with Australian institutions

A second approach to knowledge-based assistance is building partnerships between partner country institutions and their counterparts in Australia. The peer-to-peer partnership model is a strong feature of the Indonesia portfolio, where the Government Partnership Fund—Phase II (GPF: AUD118 million; 2011–17) supports 13 such partnerships, in areas such as public financial management, revenue raising, finance sector regulation, statistics and transport safety. They include long-term (2 to 4 year) resident advisers from Australia in Indonesian institutions, as well short-term visits and exchanges in both directions. The model is a decentralised one, with each partnership setting its own priorities and reporting on its results. In Vietnam, the Productivity Commission and the Australian Competition and Consumer Commissioner has been involved in the RCV program, and there has been some peer-to-peer engagement in the agriculture and water sectors. Peer-to-peer partnerships have also been established in the regional program. The Australian Securities and Investments Commission, for example, shares Australia's approach to financial technology regulation with ASEAN countries.

Key stakeholders (in DFAT and counterpart institutions) identified that this form of assistance offers some strengths, including:

1. The counterparts value the opportunity to interact with Australian peers, who offer up-to-date knowledge of current issues that may not be available from the consulting market.
2. The assistance may be more sustainable than technical support delivered through contractors or the MDBs.
3. The partnerships help to build ties between individuals and institutions in the two countries. As well as fostering knowledge and understanding of Australia, they build operational linkages, to the benefit of both sides (Box 11).

Box 11: The peer-to-peer partnership on financial intelligence

A strong example of peer-to-peer partnership is the cooperation between the Australian Transaction Reports and Analysis Centre (AUSTRAC) and the Indonesian financial intelligence agency, PPATK. PPATK uses financial intelligence to combat tax evasion, money laundering and the financing of terrorism. It generates 80 per cent of the cases for Indonesia's anti-corruption commission. AUSTRAC offers support on policy and regulations, information technology and staff training. According to PPATK's management, the development of operational links between the two institutions is of considerable practical value, given the cross-border nature of their work. AUSTRAC informed the evaluation team that it has also given Australia an ally in pursuing wider regional cooperation on counter-terrorism financing.

Source: Key stakeholder interviews.

Peer-to-peer partnerships present other challenges.

» According to the GPF design document, there are challenges with matching skills on offer from the Australian partner to the needs of the Indonesian counterpart. As a result, peer-to-peer support is not necessarily able to support the highest priority reforms of the Indonesian agencies.[70] Several Indonesian counterparts suggested the role had to be tailored to the skills of the deployee.

70 DFAT, *Australia Indonesia Government Partnerships Fund Phase II 2010–15: Design*, Australian Government, undated.

» Australian agencies must be willing to invest in building their knowledge of good practice in capacity building as well as building their knowledge of the partner country and its program management systems. Reviews of earlier iterations of the GPF in Indonesia, for example, found that if agencies are not fully committed, this may damage the partnership.[71]

» Peer-to-peer relationships may lead to an overreliance on training as the dominant form of support. The literature suggests that capacity gaps, while widespread in middle-income contexts, are not usually the binding constraint on organisational performance or policy reform.[72]

» Australian experience may not always be the most relevant to the needs of the partner country. It may be more appropriate to facilitate the counterparts' access to experience from elsewhere in the region.

» Where monitoring responsibilities are devolved to the Australian government agencies involved, the quality of reporting and results management is not necessarily strong, which makes it difficult to assess what is being achieved.[73]

DFAT Indonesia is bringing GPF and AIPEG together into a single facility, with a shared set of strategic planning and results reporting processes. This may help to address some of these challenges.

Trust funds with multilateral development banks

Once Asian MICs have graduated from the concessional windows of MDBs, there is a shortage of grant money available to fund project preparation, analytical work and technical assistance. In both countries, Australia is helping to fill this gap through establishing bilateral trust funds. Posts pointed to a number of positive contributions that these funds are making to economic partnerships and Australia's ability to support policy and institutional reform.

» MDBs offer a depth of technical expertise in economics and other policy areas and comparative experience from around the world that would be difficult for DFAT to engage directly.

» With their mandates and status, MDBs can challenge partner countries on their policy choices in ways that would be considered inappropriate for a bilateral donor.

» Trust funds can offer a means of influencing the design of MDB loans. In Indonesia, for example, Australian-funded technical assistance helped to pilot new ways of financing local development projects designed to strengthen community participation and local governance. These innovations were then implemented at scale by government through its National Program for Community Empowerment, with funding from a World Bank loan.

DFAT Indonesia also noted some weaker aspects of the World Bank's work, compared to Australian bilateral programs, including less use of senior Indonesians as intermediaries with government and less investment in political economy analysis. The World Bank also gives less attention to cross-cutting issues such as gender, disability and working with civil society.

A 2015 ODE evaluation of non-core funding to the MDBs[74], which accounts for around 10 per cent of the Australian aid budget, found that it can be efficient and effective, particularly when it helps to strengthen national policies and institutions. This funding works best where DFAT remains closely engaged in programs, contributing country knowledge and expertise and helping to provide strategic direction. Active participation is also important to secure recognition of the Australian contribution.

The findings in this evaluation mirror those of the 2015 evaluation. In Indonesia, Australian support through the World Bank is designed to complement other bilateral investments. There is a regular strategic dialogue with the World Bank and DFAT participates actively in joint policy-related events with the Bank. There was some concern among DFAT staff that the Bank's own strong brand may obscure Australia's. Nonetheless, the partnership is seen as enhancing Australia's profile and reputation. In Vietnam, the smaller DFAT Post has less time to engage with the World Bank trust fund and oversee its 34 activities. The investment has nonetheless provided DFAT with opportunities to interact with Vietnamese policy makers and attend key policy events.

Infrastructure investments

Infrastructure projects have played a major role in Australian assistance to Indonesia and Vietnam (Box 12). In Vietnam, two large bridge projects over the past two decades have been symbols of Australia's development cooperation. In both countries, Australian is moving away from direct financing of infrastructure development towards facilities

71 ODE, *Assessment of the Indonesia Country Program Strategy 2003–2006,* Australian Government, September 2007, p. 12.

72 See, for example, Katherine Bridges and Michael Woolcock, *How (Not) to Fix Problems that Matter: Assessing and Responding to Malawi's History of Institutional Reform*, World Bank Policy Research Working Paper, no. 8289, December 2017.

73 DFAT, *Aid Quality Check for Governance Partnership Fund Phase II,* Australian Government, April 2016.75

74 ODE, *Banking our aid: Australia's non-core funding to the Asian Development Bank and the World Bank*, Australian Government, September 2015.

designed to help strengthen national infrastructure policy and expenditure and support public-private partnerships. Similarly, the ASEAN and Mekong program supports ASEAN to develop and maintain a transparent rolling pipeline of priority regional infrastructure projects, as well as providing technical assistance and advice on soft infrastructure to facilitate trade and transport across the Mekong.

Infrastructure projects in the two countries have increasingly combined investment projects with influencing objectives, seeking to demonstrate the value of well designed and implemented projects. There is mixed evidence about how significant the demonstration effects have been. EINRIP delivered some of the highest quality roads in Indonesia, but according to an ODE evaluation had only a 'modest-to-moderate' influence on the Indonesian roads sector.[75] While some of the good practices showcased in EINRIP projects were picked up in government-financed infrastructure development, the package as-a-whole was not replicated, partly because the Indonesia Government was unwilling to pay the costs of high-quality engineering designs and technical audit. Furthermore, lessons from EINRIP's monitoring and evaluations were not absorbed by government institutions.

IndII had more ambitious objectives around policy and institutional reform. It focused on catalytic policy change in areas such as performance incentives (including output-based procurement) and leveraging private finance. One of the program's main successes was to demonstrate the effectiveness of output-based funding for household water and sanitation connections. This has been taken up by government and applied to hundreds of millions of dollars in national investments.

It is a matter of debate how important it is for infrastructure programs to support reform objectives with investment finance. Some DFAT stakeholders take the view that Australia needs to have skin in the game to be influential in the sector. However, the mixed record on pilot or demonstration projects suggests they need to be carefully integrated into national decision-making processes if they are to influence other investment projects. In Indonesia, the evaluation team heard from DFAT and its implementers that large budgets can force infrastructure programs into activities that can absorb the expenditure, such as pilot projects or large engineering studies, rather than focusing on less expensive but potentially more strategic support for policy and institutional reform. The new Aus4Transport program in Vietnam, which is in its inception phase, will focus on feasibility studies, project preparation and procurement, with a view to unlocking major MDB-financed projects, boosting their quality and increasing private sector participation. The program does not include any substantial budget for construction work.

Box 12: Infrastructure projects in Indonesia and Vietnam

In Indonesia, Australia provided an AUD300 million loan for road building following the 2004 tsunami, supporting 20 major road projects (EINRIP; 2005–16). It has also provided a series of facilities that combine technical assistance with support for project preparation and funding for demonstration projects, including IndII (AUD239 million; 2007–17) and its successor, the Indonesia Australia Partnership for Infrastructure (AUD300 million; 2016–26).

In Vietnam, Australia has invested in two flagship bridge projects over the past 20 years, the My Thuan Bridge (AUD90 million; 1998–2003) and the Cao Lanh Bridge (AUD160 million; 2011–17). These high-profile projects represent Australian development cooperation. They also provide economic benefits by improving connectivity in the Mekong Delta. The Cao Lanh Bridge is funded through the Asian Development Bank and implemented by a Chinese contractor, raising concerns that it provides less visibility for Australia. However, the project has demonstrated how complex projects can be delivered on time and on budget. Australia's technical assistance has also promoted good practice on safeguarding issues such as resettlement and climate proofing.

Source: Program documents and key stakeholder interviews.

75 ODE, *Investing in Roads—Lessons from the Eastern Indonesia National Roads Improvement Project*, Australian Government, March 2017

The evaluation team's view is that the value added from Australian support for infrastructure in MICs lies in helping to mobilise and make better use of other sources of development finance, rather than in increasing the overall financing pool. This differentiates Australian support from that of other countries, such as China, which can offer larger volumes of finance but without any ambition to strengthen the overall quality of national infrastructure development. In Indonesia and Vietnam, DFAT is at an early stage in trialling new forms of infrastructure support and it is too soon to draw firm conclusions. There may still be a case for pilot work in infrastructure programs, but the demonstration effects cannot be assumed. Pilots should be part of a considered strategy for achieving policy and institutional change and avoid taking over as the primary activity.

KEY MESSAGES

- There is still much to be learned about effective knowledge-based assistance. While there are examples of effective support in Indonesia and Vietnam, approaches tend to be unique to circumstances and are not necessarily replicable.
- To be an effective partner for national reformers, Australia needs to build long-term relationships with key counterparts, while retaining the flexibility to scale individual activities up and down as the context evolves. Economic governance facilities are one way of achieving that flexibility.
- Peer-to-peer partnerships can be effective at building bilateral links but are not as well suited to supporting complex or large-scale national reform priorities.
- While MDB trust funds can bring additional technical expertise and credibility to economic partnerships, they need to be accompanied by continuing DFAT engagement and oversight.
- The value added from continuing Australian support for infrastructure in Asian MICs lies in helping to mobilise and make better use of other development finance and managing debt levels sustainably.

HOW WELL DO DFAT'S SYSTEMS AND CAPACITIES FACILITATE THE EFFECTIVE USE OF AID TO STRENGTHEN ECONOMIC PARTNERSHIPS?

This section considers whether the positioning of aid to support economic partnerships calls for further development in DFAT's systems and capacities.

Strategy

While the focus and strategies used by the aid program are changing in support of its economic partnerships with Asian MICs, DFAT has not yet fully articulated objectives and strategies for its economic partnerships with each country. The term 'economic partnership' appears in aid investment plans for Indonesia, Vietnam and a number of other countries, but without identifying specific goals for each partnership. The nature and goals of the partnerships have also not been agreed with the partner countries. This inhibits closer alignment between aid, trade and economic diplomacy.

DFAT is considering whether to develop integrated country and regional strategies that set out the Australian Government's high-level foreign policy, development, security and economic priorities. These would then inform the preparation of aid investment plans setting out how Australian aid will help address these priorities.

To support economic partnerships with Asian MICs, it would be helpful to have integrated strategies that incorporate both development and economic cooperation goals, including:

- how Australia will support the country's transition from middle to high-income status
- Australia's long-term plans for building bilateral economic ties, including increasing trade and investment and supporting sectors of the economy that are of particular interest

This would help DFAT identify a set of medium-term outcomes, such as specific policy or institutional reforms, to be pursued through development cooperation, diplomatic engagement and, where appropriate, trade negotiations. A clearly articulated set of influencing priorities would help align these efforts and ensure consistent messaging both within DFAT and with other Australian government agencies.

There may also be a case for developing region-wide strategies in specific sectors or areas. This is because some of Australia's economic objectives are regional in nature, such as promoting economic integration, preventing financial crises and promoting open labour markets. These can become cross-cutting objectives across all the economic partnerships. Australia may also have objectives for sectors or industries, such as promoting tourism, opening up regional food markets or promoting Australian export of education services.

Analytical work

While there is good research and analysis completed for individual aid programs, there is no structured process for pulling together the available knowledge, to guide aid investment plans and the design of aid programs. DFAT's aid investment plans are not informed by economic growth diagnostics or a structured approach to learning and knowledge management.

To maximise the effectiveness of aid in strengthening economic partnerships, DFAT needs to build an understanding of the:

- opportunities to promote and the constraints on achieving more productive economies and stronger growth in Asian MICs
- causes of inequality, including the barriers that prevent poor and marginalised groups from benefiting from economic growth, and the risks that inequality poses to growth and stability
- key institutional and policy gaps for economic transition, and the constituencies that support or resist reform
- risks that could set back economic growth, such as climate change, demographic shifts or financial crises, and how to mitigate their impact.

This knowledge can be built over time, including through analytical work within programs. It should be periodically brought together and synthesised.

DFAT has a partnership with The Asia Foundation to develop a deeper understanding of middle-income traps in Asia. There are plans to move towards developing a diagnostic tool that can be used in countries to identify the main blockages to economic transition and how they might be addressed. This might offer a framework to synthesise the available knowledge.

Capability

The rebalancing within economic partnerships from bricks and mortar projects to knowledge-based assistance has implications for the capabilities that DFAT needs in its posts. Some of the DFAT staff responsible for managing knowledge-based programs noted that they involve a greater management burden, relative to the expenditure. Flexible and adaptive programs require oversight to ensure they remain coherent and focused on DFAT's objectives. Australia also gains greater benefits, in terms of profile and reputation, if DFAT participates actively in policy dialogue and relationship building, rather than delegating to implementers.

There is a widespread perception within DFAT that the department's capacity to manage development cooperation in Asian MICs has declined over time, in parallel to declining aid budgets. In interviews, skills gaps, a lack of cross-disciplinary team work and competing pressures on staff time were suggested as explanations. It was agreed that more ambitious economic partnerships would require a higher level of economic literacy. This does not necessarily mean that aid programs in economic partnerships should be managed by economists. Some of the required technical expertise can be bought in. However, DFAT staff need a sufficient understanding of economic and social policy issues to absorb the analytical work they receive from program teams and to understand and engage with policy debates.

Trade expertise was identified as a particular gap. This is mainly located in Canberra, rather than at post. This may help to explain why the regional and multilateral trade facilitation work is not well integrated with country programs. To develop a more ambitious approach to using bilateral aid to support the implementation of free trade agreements, DFAT would need to encourage more cross-disciplinary working and greater interaction between staff in posts and trade experts in Canberra.

The evaluation team conducted workshops with locally engaged staff in Indonesia and Vietnam. In both cases, there was consensus that these staff were an underused resource, and that their contextual knowledge and networks across government were not sufficiently valued. Their role is primarily administrative. They are not party to internal discussions on strategy, partly because they are unable to view confidential cables. The evaluation team received requests from locally engaged staff in both posts for a clearer explanation of the economic partnerships concept and their role within it.

Adaptive programming

The technical assistance facilities reviewed for this evaluation reflect current thinking on good practice in knowledge-based assistance. They approach policy dialogue and capacity development in a politically informed way. They are designed to be flexible and adaptive, able to try out a range of activities and scale them up or down, depending on progress. They use problem-solving approaches to support policy making and implementation, address blockages and promote learning. They recruit good people. They are willing to invest in areas with uncertain but potentially high returns. They are patient and pursue long-term objectives over two or more project cycles.

Monitoring and reporting results

DFAT Posts in Indonesia and Vietnam are taking steps to improve their systems for capturing results from knowledge-based programming. Indonesia tasks its programs to report on significant policy changes, using a robust methodology to ensure changes reported are genuinely significant and attributable to Australia. In its Performance Assessment Framework, it records significant policy changes that Australian aid has helped to bring about and the volume of other development finance that Australia has leveraged. Annual milestones set out the changes that DFAT hopes to see in each objective area, which aid programs contribute and which PAF indicators are relevant.

The Performance Assessment Framework format is useful, but with scope for improvement. It would also be useful to track how much the policy changes to which Australia has supported have contributed to advancing the goals of the economic partnership. If the objectives include, for example, improvements to the business environment, overall results should be measured in terms of progress towards that goal. This would call for adaptation of existing results and knowledge management practices so they include:

- Annual assessment of the trajectory of change towards higher-level objectives (for example, increased trade or reduced inequality), recognising that changes at this level are unlikely to be directly attributable to Australian support.
- Periodic reassessment of whether the aid program continues to address the most important constraints on achieving those objectives and whether new opportunities have emerged that it should respond to.
- A rolling program of analytical work to deepen DFAT's understanding of policy challenges or issues.
- A periodic health check on how well positioned DFAT is to achieve its influencing objectives. This could assess whether it is working with the right counterparts, has the right level of access to decision-makers, and is communicating with the right external stakeholders to build constituencies for change. This might include assessing whether public diplomacy is targeting the right audiences with the right messages.

As these activities are resource intensive, an option could be to give one of the aid investments a cross-cutting role in supporting analysis, knowledge management and results monitoring across the whole economic partnership. In Indonesia, there was an attempt to give the Knowledge Sector Initiative a coordinating role on DFAT's approach to policy engagement, but it did not proceed because of capacity constraints across the portfolio. It may be worth exploring this idea again, to provide posts with a way of resourcing analytical inputs and coordinating monitoring and knowledge management across the portfolio.

Learning

It is notable that, while a number of programs in Indonesia, Vietnam and at regional level are grappling with the question of how to provide knowledge-based support more effectively, there is no structured process for learning, either among responsible DFAT staff or implementers. The evaluation team did not come across any examples of DFAT bringing its implementers together to exchange knowledge or experience. Some form of community of practice among DFAT staff might be useful to promote the exchange of learning on what works in knowledge-based assistance. It could also be used to disseminate understanding of relevant social and economic policy issues in Asian MICs.

KEY MESSAGES

More ambitious economic partnerships would call for development of DFAT systems and capacities in these areas:

- economic partnership strategies for each country, identifying shared objectives for aid, trade and diplomatic engagement
- a program of diagnostic work tailored to the challenges of Asian MICs, to help identify priority engagements
- increased capacity at post on economic and social policy issues, and on the working of complex policy processes, to support strategic engagement with counterparts and implementers
- more of a focus on results management at the country portfolio level, to monitor progress towards economic partnership objectives.

RECOMMENDATIONS

1. DFAT should set out the long-term strategic case for development cooperation in support of economic partnerships with middle-income Asia, and how the quantum and approach to providing assistance might be expected to evolve as the partnerships develop.
2. Within each of its economic partnerships with ODA-eligible countries, DFAT should:
   - » articulate influencing objectives and ensure that messaging is consistent across its aid, trade and diplomatic engagements
   - » focus its aid for trade investments on helping partner countries to take advantage of opportunities in bilateral and regional free trade agreements
   - » look for opportunities to provide development assistance in sectors that offer the potential for mutual benefit, in ways that meet the conditions for good development practice.
3. DFAT should continue to develop the evidence base, technical expertise and guidance on the design and implementation of knowledge-based assistance, covering issues such as how to:
   - » analyse policy-making processes in partner countries and identify opportunities for knowledge-based inputs to support policy and institutional reform
   - » position aid programs to be useful partners to national reformers and build long-term relationships
   - » apply problem-solving approaches to assistance, combining short-term flexibility in activities and outputs with clarity in strategic objectives
   - » engage with and oversee implementers and multilateral partners
   - » design and implement influential pilots.
4. DFAT posts should encourage more interaction among their knowledge-based programs, for exchange of lessons and experience.
5. DFAT should ensure future country and regional strategies for development assistance to MICs:
   - » are underpinned by suitable diagnostic work that identifies opportunities for, and constraints on, inclusive growth and transition to an advanced economy
   - » include a set of medium-term policy and institutional reform objectives, with a shared advocacy strategy to be pursued across aid, trade and diplomatic engagements and by other Australian government agencies where relevant
   - » identify sectors or areas where development cooperation can support national development goals and Australian economic interests.
6. DFAT should ensure that posts in economic partnership countries:
   - » have enough staff conversant on economic and social policy to engage in policy dialogue and manage knowledge-based programs and portfolios at a strategic level
   - » take measures to promote cross-disciplinary working, including with the trade area.
   - » examine ways to take better advantage and further develop the capabilities of their locally engaged staff, as a critical resource for pursuing economic partnerships
   - » have access to country-level monitoring and knowledge-management tools to assess progress against key reform objectives, the significance of Australia's contribution, the ongoing relevance of its work and the health of the economic partnership.
7. DFAT should consider establishing a multidisciplinary community of practice among staff on economic partnerships, to share knowledge and experience on engaging with social and economic policy issues.

ANNEXES

ANNEX A: PROGRAM SAMPLE

Program	Area	Dates	Budget (million AUD)	Influencing activities
Indonesia				
Indonesia Infrastructure Initiative (IndII) program	Infrastructure	2007–17	239.4	Technical assistance to address constraints to infrastructure investment and related policy and regulations. Responds to requests from Indonesia Government agencies for feasibility studies, cost-benefit analyses, planning documents, engineering and architectural designs, project evaluations, and training on important infrastructure projects.
Eastern Indonesia National Roads Improvement Project (EINRIP)	Infrastructure	2005–16	300 loan 35 grant	In addition to the reconstruction of roads and bridges across nine provinces in Eastern Indonesia, the program provided technical assistance to improve project planning, implementation and oversight by the Directorate General of Highways. It also included a monitoring and evaluation component to assess the social and economic impact and build an evidence base for future application of improved construction practices.
Government Partnership Fund (GPF) Phase II	Economic governance	2011–17	74	Whole-of-government program involving 13 Australian agencies working within Indonesian counterpart agencies to improve economic and public sector governance.

Program	Area	Dates	Budget (million AUD)	Influencing activities
Australia Indonesia Partnership for Economic Governance (AIPEG)	Economic governance	2009–18	112	Contractor-managed facility supporting Indonesia Government agencies to achieve inclusive growth through increased competitiveness. Technical assistance and capacity building to strengthen economic institutions, manage public finances and promote effective markets.
Australia-Indonesia Partnership for Pro-Poor Policy: The Knowledge Sector Initiative (KSI)	Economic governance	2016–19	64	Contractor-delivered program building the capacity of Indonesian think tanks to stimulate the production and use of quality research and analysis for policy makers.
Towards a Strong and Prosperous Indonesian Society (MAHKOTA Indonesia)	Social protection	2016–19	62	Contractor-delivered program that supports the Vice President's National Team for the Acceleration of Poverty Reduction (TNP2K) to enhance existing social protection programs and work towards a comprehensive social protection framework. Generates knowledge and formulates options to guide policy development, helping to translate policy choices into programs, provides technical advice, and high-quality monitoring and evaluation. Builds on past work towards a unified database. Designing a compensation package to reform electricity subsidies.
Vietnam				
Restructuring for a More Competitive Vietnam (RCV)	Economic governance	2014–17	3.6	Supports the development of policies, laws and institutions through advocacy, consultation and strengthening the evidence base, drawing on Australian and international experience and expertise. Works with reform champions with access to influential networks and helps to build coalitions for reforms, using a flexible delivery approach.

Program	Area	Dates	Budget (million AUD)	Influencing activities
Australia-World Bank Strategic Partnership in Vietnam, Phases 1 and 2	Economic governance	2012–16 2016–21	30.5 25	World Bank partnership supports the Vietnam Government with analytical and advisory work in critical policy and reform agendas. It includes technical assistance to support World Bank lending operations, leading to better program preparation, implementation and evaluation. The new phase offers research, analysis, policy dialogue and technical assistance under five themes—trade and competitiveness, transport, Mekong Delta climate resilience, gender, ethnic minorities.
Cao Lanh Bridge	Infrastructure	2011–18	160	In addition to the construction of the bridge to high technical standards, the program includes technical assistance, demonstration models on good practice in infrastructure development and policy dialogue.
ASEAN and Mekong program				
ASEAN-Australia Development Cooperation Program Phase 2	Economic cooperation	2008–19	57	A partnership program between Australia and ASEAN that supports implementation of the ASEAN Economic Community through economic research and policy advice in priority sectors, including investment, trade in services, consumer protection, connectivity and financial integration.
ASEAN Australia New Zealand Free Trade Agreement (AANZFTA) Economic Cooperation Support Program	Economic cooperation	2010–18	26.5	Support for ASEAN countries to maximise the benefits of the AANZFTA, which includes implementing its commitments, promoting business utilisation of its opportunities and advancing economic integration.
Mekong Business Initiative	Business environment	2013–18	13.8	Joint program with the Asian Development Bank to promote private sector development in Cambodia, Laos, Myanmar and Vietnam, focusing on the business environment, access to finance and innovation, with additional support for young entrepreneurs, especially women.

Program	Area	Dates	Budget (million AUD)	Influencing activities
Shaping Inclusive Finance Transformations (SHIFT) in ASEAN	Financial inclusion	2014–18	9.9	Partnership with the United Nations Capital Development Fund to support low-income people, particularly women, access and use well-regulated and affordable financial products and services for productive activities. Combination of private sector challenge funds, data mapping of national financial inclusion; regional (ASEAN) and national policy advocacy; and capacity building of financial service providers to be more inclusive across Cambodia, Laos, Myanmar and Vietnam.
Greater Mekong Sub-region Trade and Transport Facilitation (GMS TTF) Program	Trade facilitation	2011–17	6	Partnership with the Asian Development Bank to provide technical assistance to improve cross-border trade between Cambodia, Laos, Myanmar, Vietnam, Thailand and China.

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