



**POLICY OPTIONS AND CHALLENGES
FOR DEVELOPING ASIA—
PERSPECTIVES FROM THE IMF AND ASIA
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**COMMENTS ON
“BUDGET SUPPORT AND
AID EFFECTIVENESS:
EXPERIENCE IN EAST ASIA”**

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Comments on
“Budget Support and Aid Effectiveness: Experience in East Asia”

by

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The issue of aid effectiveness continues to attract much useful commentary and Mr. Arakawa’s paper is a substantial and welcome addition to this literature. The paper succinctly presents the modalities of donor assistance, including project support, sector support and program aid and the further subdivision of program aid into general purpose budget support and sector specific support. In the interests of aid effectiveness, Mr. Arakawa rightly underscores the need to ensure that ODA should reinforce a recipient country’s development priorities and help enhance its public financial management. In the same vein, he observes that the utility of ODA is likely to be increased if assistance is provided in a predictable manner over the longer term. The more effectively donors coordinate the provision of aid flows and the more consistently they support a common set of recipient country policies, the more likely it is that aid will have a positive developmental impact.

Japan’s ODA strategy has attempted to follow these principles, it has also as the paper indicates, pursued a sectoral approach which channels funds into infrastructure on the grounds that: this ensures a fuller absorption of the resources with the minimum of adverse macroeconomic spillovers; that it crowds-in FDI; and that directly and via the induced FDI, it promotes growth. Because many developing countries are faced with infrastructure gaps which impede industrialization and trade, the Japanese approach if it delivers results has much to recommend it. Building infrastructure loosens constraints, transfers skills, equipment and technologies in key areas and physical infrastructure provides tangible evidence of resource transfer. The return on transport and some other infrastructure projects is generally high, and there is limited evidence pointing to a link between infrastructure investment and economic growth.

Does this suggest that the sector oriented strategy for providing ODA has proven effective and should remain the preferred approach? This question needs to be tackled at three levels.

First, at the aggregate level, what is the apparent relationship between ODA and growth? A substantial literature has accumulated on this topic – one recent count came up with 97 papers – and the relationship appears weak at best. A meta analysis of 29 studies empirically assessing the links between aid and investment finds no statistically significant effects (Doucouliagos and Paldam 2006). A further meta analysis of 24 studies examining the effect of aid on savings shows that on balance, ODA causes “domestic savings to fall and this will crowd out investments, but there need not be a full crowding out” (p.245). “About 25 percent of the aid is invested, while 75 percent is crowded out by a fall in the domestic absorption of savings mainly caused by increasing public consumption crowding out public savings” (p.246). A thorough recent study by Rajan and Subramanian (2006) also fails to find evidence of “robust positive correlation between aid and growth” (p.4) in spite of efforts to remove biases through instrumentation. This complements earlier work showing that aid can fail to deliver results even when countries are pursuing “good policies” (Easterly, Levine, and Roodman 2003). There is in addition, the widely cited work of Easterly (2006) marshaling evidence which gives rise to doubts over the efficacy of ODA as against other forms of piecemeal and targeted assistance. Overall the findings of this meta study and other literature appears to suggest that the relationship between ODA and growth is uncertain. Moreover, some of the research on the efforts by aid agencies to improve their strategies and capacity to deliver aid more effectively yields very mixed results on progress thus far (Easterly 2006).

Second, does ODA crowd-in FDI? Kimura and Todo (2007) to only find a significant positive relationship between Japanese ODA for infrastructure and FDI from Japan but do not discern such a relationship in general. Severine Blaise (2005) also observes that Japanese ODA to China pulled in FDI during 1980–99 although other factors such as the level of economic activity contributed. FDI has had a substantial role in China’s export oriented industrialization with foreign- invested firms accounting for 60 percent of exports and close to one fifth of GDP (Whalley and Xin 2006). If ODA for

infrastructure can crowd in FDI then its indirect link with growth can be significant. But how robust is this result? This point deserves careful investigation because; inclusion of other variables or a change in the time period covered for example can dramatically alter the results, so can endogeneity between ODA and Japanese FDI. It also needs to be noted that research on FDI rarely identifies Aid or ODA for infrastructure as a significant determinant.

An OECD (2004) study, which drew upon the several different techniques used to measure country performance – such as “Doing Business”, “Investment Compass”, Index of Economic Freedom etc. – to identify the factors with the strongest bearing on FDI, did not single out ODA or infrastructure as the key variables. The ones which mattered most were GDP per capita, population, regulatory quality, government intervention, macroeconomic stability and availability of skills. Other findings on this topic have pointed to tax and financial incentives as additional attractors of FDI. That Japanese FDI responds to Japanese ODA is of importance. How much this contributes to growth of the recipient country and whether this relationship is likely to persist, are questions which deserve to be explored further.

How ODA can impinge upon the longer term sustainability of infrastructure projects is a third question. Mr. Arakawa points out that when programs are properly implemented they can raise tax revenues and “once the projects are completed, the required subsequent expenditures are relatively limited only to the operation and maintenance expenditures.” Unfortunately, many low income countries lack the institutional capabilities and the organizations to maintain facilities. They are hobbled by the inability to mobilize the fiscal resources from user charges, fees or other taxes to sustain, improve and operate infrastructure after it had been constructed with the help of ODA. Furthermore, Djankov, Montalvo, and Reynal-Querol (2006) suggest that aid might detract from the quality of democratic institutions and could undermine other capacities critical to the efficient management of an economy’s assets, such as the effectiveness of public bureaucracies and the rule of law (Knack 2001).

Research on ODA argues for caution in assessing the benefits realized by the recipient countries and Mr. Arakawa’s paper could have briefly summarized the findings. Even Bill Easterly does not deny that various forms of assistance can be effective in

promoting development. But in order to establish the utility of ODA, sectoral or other, it is necessary not only to adhere to broad principles and the recipient country's development plans as Mr. Arakawa notes, but also to justify these principles in the light of the criticisms raised and demonstrate empirically that the objectives of more rapid growth were achieved because of ODA directly, and indirectly through its well-defined link with FDI.

The paper, describes the JBICs efforts to follow good practices in delivering ODA to Tanzania and Vietnam in coordination with government agencies. This account could be supplemented in three ways. First by stating what were the sectoral or growth criteria JBIC has specified to evaluate the outcomes of ODA for the two countries. Second, the extent to which ODA has been instrumental in achieving the performance criteria specified. And third, the lessons learned and how these can be translated into more effective ODA strategies which according to the critics, have proven elusive to date.

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