POLICY OPTIONS AND CHALLENGES
FOR DEVELOPING ASIA—
PERSPECTIVES FROM THE IMF AND ASIA
APRIL 19-20, 2007
TOKYO

# BUDGET SUPPORT AND AID EFFECTIVENESS: EXPERIENCE IN EAST ASIA


HIROTO ARAKAWA
JAPAN BANK FOR INTERNATIONAL COOPERATION



*Paper presented at the Conference: POLICY OPTIONS AND CHALLENGES FOR DEVELOPING ASIA—PERSPECTIVES FROM THE IMF AND ASIA*
*Organized by the International Monetary Fund (IMF) and*
*Japan Bank for International Cooperation (JBIC)*
*April 19-20, 2007*
*Tokyo, Japan*

# Budget Support and Aid Effectiveness: Experience in East Asia[1]

Hiroto Arakawa[2]

## I. Introduction

Reflecting the favorable international financial conditions, the developing countries recently enjoy an ample flow of private capital. The fiscal space created after the debt relief initiatives—Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Reduction Initiative (MDRI)—is another factor behind the private sectors' strong appetite on the developing countries debt.

Concurrently, a significant part of the donor aid flows are recently provided in the form of budget support, rather than the project aid as has been the case before. Some donors argue that the budget support aid carries several advantages than the project aid and that the budget support should be mainstreamed in the development aid.[3] This change in the aid modalities grants the developing countries more autonomy in the use of development fund.

Such improving availability of fund as well as the increasing share of the budget support, while welcomed for the developing countries' effort to achieve the development objectives, needs to be reviewed carefully as they carry some risks in the overall economic management.

This paper aims to review the experience of the Japan's ODA in East Asian countries especially Vietnam in the context of policy framework recently presented by the IMF, and tries to examine the validity of Japan's aid philosophy under the changing environment of development finance.

---

[1] This paper draws on my previous paper with the same title (Arakawa (2006)), and tailored to properly fit the seminar objective, with the contribution by Mr. Ryosuke Nakata, Senior Representative, JBIC Washington D.C. office. The author would like to thank for comments by the discussants (Mr. Shahid Yusuf and Ms. Sumie Shimamura) and other participants at the IMF-JBIC seminar held on April 19–20, 2007, as well as Mr. Hiroyuki Hino, former IMF Director, Regional Office for Asia and Pacific, who reviewed the earlier draft. Any remaining errors, of course, are attributable to the author. Views expressed are those of the author and not necessarily represent the official view of JBIC or IMF.

[2] Executive Director, Japan Bank for International Cooperation

[3] This interest arose out of the discussions of the late 1990s on aid effectiveness, which in turn arose from several different perspectives, including (1) the argument that aid works in a good policy environment; (2) greater focus and linkage between debt relief (HIPC Initiative) and poverty reduction (PRSPs), such as allocation of HIPC relief funds to pro-poor expenditures; (3) greater focus on aid that supports effective processes based on the recipient country environment; (4) greater focus on aid effectiveness (ownership, alignment, harmonization, and so on and the trend toward SWAps, program-based approaches; and (5) volume of aid to meet the Millennium Development Goals.

The organization of this paper is as follows: **Section II** discusses the recent characteristics of the international financial flows, followed by some preparatory discussion on the advantage/disadvantage of various modalities of development aid as well as the risks associated with the increasing availability of the fund. **Section III** discusses the policy framework recently developed by the IMF. In response to the global attention to the Millennium Development Goals (MDGs), the developing countries have been urged to allocate a significant part of the resources to the social sector programs such as education and health. According to this framework, however, such expenditure allocations carry some risks in the overall macroeconomic management. In **Section IV**, the Japan's experience in the ODA program for Vietnam is discussed. It is shown that the Japan's strategy in Vietnam was in line with the above policy framework. In **Section V**, the selection of appropriate aid modality is discussed using the comparison between Vietnam and Tanzania. In **Section VI**, some policy lessons are drawn as concluding remarks.

## II. Characteristics of Financial Flows to Developing Countries and Emerging Risks

### a. Characteristics of recent international capital flows

Recent improvement in the international financial condition brought about significant changes in the developing countries' finance pattern. Three major characteristics can be observed, namely;

(a) Reflecting the widening current account *surplus* in the developing countries and the widening current account *deficit* in the developed countries (mainly the United States), the international capital flows are directed from developing countries (especially China and resource rich countries) to developed countries (especially the U.S.) in the form of accumulated foreign reserves by the former;

(b) Within the external finance of the developing countries, the official flows have become negative in net basis while the private capital flows such as FDI and loans are growing significantly;[4] and

(c) With regard to the official flows, a new trend emerges as the nontraditional donors (such as China, India, and Brazil) expand their flows to the poorer countries among developing countries.

[4] Another important and growing source is the private remittance which is reflected in the widening current account surplus in the developing countries. If remittance and private capital flows are combined, the diminished importance of official flows is shown in a more striking manner.

**Table 1. External financing: all developing countries**
(in US$ billions)

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|
| Current account balance | -89.2 | -3.5 | 47.8 | 20.5 | 72.0 | 123.8 | 158.3 | 245.8 |
| ***Financial flows:*** | | | | | | | | |
| **Net equity flows** | **179.4** | **195.9** | **182.9** | **183.3** | **166.1** | **186.8** | **248.8** | **298.9** |
| **Net FDI inflows** | **172.4** | **183.3** | **168.8** | **176.9** | **160.3** | **161.6** | **211.5** | **237.5** |
| - East Asia and Pacific | 57.8 | 50.8 | 44.3 | 48.5 | 57.2 | 59.8 | 64.6 | 65.3 |
| - Europe and Central Asia | 27.4 | 29.7 | 30.2 | 32.7 | 34.9 | 35.9 | 62.4 | 75.6 |
| - Latin America and the Carribean | 74.1 | 88.3 | 79.3 | 71.1 | 48.2 | 41.1 | 60.8 | 61.4 |
| - Middle East and North Africa | 2.7 | 2.4 | 4.1 | 3.4 | 3.7 | 5.6 | 5.3 | 9.1 |
| - South Asia | 3.5 | 3.1 | 4.4 | 6.1 | 6.7 | 5.6 | 7.2 | 8.4 |
| - Sub-Saharan Africa | 6.9 | 9.0 | 6.5 | 15.0 | 9.5 | 13.6 | 11.3 | 17.6 |
| **Net portfolio equity inflows** | **6.9** | **12.6** | **14.1** | **6.4** | **5.8** | **25.2** | **37.3** | **61.4** |
| **Net debt flows** | **54.3** | **16.3** | **-1.0** | **-1.5** | **10.7** | **72.8** | **119.1** | **120.1** |
| **Official creditors** | **34.3** | **13.9** | **-5.7** | **27.4** | **5.2** | **-12.3** | **-28.7** | **-71.4** |
| (By creditors) | | | | | | | | |
| World Bank | 8.7 | 8.8 | 7.9 | 7.5 | -0.2 | -0.9 | 1.3 | 0.7 |
| IMF | 14.1 | -2.2 | -10.7 | 19.5 | 14.0 | 2.4 | -14.7 | -41.1 |
| Others | 11.5 | 7.3 | -2.9 | 0.4 | -8.6 | -13.8 | -15.4 | -31.0 |
| (By debtors) | | | | | | | | |
| - East Asia and Pacific | 14.7 | 12.5 | 7.0 | 3.2 | -7.9 | -7.4 | -5.5 | -1.9 |
| - Europe and Central Asia | 7.5 | -0.6 | 0.0 | 2.2 | 2.7 | -6.8 | -10.5 | -30.9 |
| - Latin America and the Carribean | 10.9 | 1.6 | -11.1 | 20.4 | 12.8 | 4.9 | -10.5 | -36.5 |
| - Middle East and North Africa | -1.6 | -2.5 | -2.7 | -1.2 | -2.5 | -2.5 | -4.1 | -2.4 |
| - South Asia | 2.3 | 2.5 | 0.5 | 2.2 | -2.4 | -1.7 | 1.0 | 3.4 |
| - Sub-Saharan Africa | 0.5 | 0.4 | 0.7 | 0.6 | 2.6 | 1.2 | 0.8 | -3.2 |
| **Private creditors** | **19.9** | **2.5** | **4.7** | **-28.9** | **5.5** | **85.1** | **147.8** | **191.6** |
| **Net MLT debt flows** | **85.7** | **22.0** | **11.5** | **-6.2** | **1.2** | **30.2** | **77.8** | **122.3** |
| - East Asia and Pacific | -3.5 | -10.9 | -13.1 | -13.0 | -12.5 | -9.2 | 9.1 | 15.8 |
| - Europe and Central Asia | 29.7 | 17.6 | 11.4 | 5.5 | 21.1 | 32.2 | 64.6 | 81.3 |
| - Latin America and the Carribean | 55.3 | 19.5 | 8.0 | -0.6 | -11.4 | 3.2 | -3.9 | 18.5 |
| - Middle East and North Africa | 1.8 | -1.4 | 0.8 | 3.8 | 4.5 | 0.2 | 2.3 | 3.7 |
| - South Asia | 3.7 | -2.1 | 3.9 | -2.0 | 0.6 | 1.3 | 3.9 | 0.6 |
| - Sub-Saharan Africa | -1.3 | -0.7 | 0.4 | 0.1 | -1.0 | 2.5 | 1.7 | 2.3 |
| **Net short-term debt flows** | **-65.8** | **-19.6** | **-6.8** | **-22.7** | **4.2** | **54.9** | **70.0** | **69.3** |
| Change in reserves (- = increase) | -16.4 | -33.2 | -45.4 | -81.7 | -171.9 | -291.6 | -404.8 | -393.0 |
| ***Memo items:*** | | | | | | | | |
| Bilateral aid grants (ex. Tech. coop grants) | 26.7 | 28.5 | 28.7 | 27.9 | 32.5 | 43.7 | 50.3 | 52.6 |
| Net private flows (debt+equity) | 199.3 | 198.3 | 187.7 | 154.4 | 171.5 | 271.9 | 396.6 | 490.5 |
| Net official flows (aid+debt) | 61.1 | 42.4 | 23.0 | 55.3 | 37.7 | 31.4 | 21.6 | -18.8 |

Source: World Bank (2006)

The private capital flow to the developing countries is estimated to have reached US$490.5 billion in 2005, higher by 23.7 percent compared with the previous year. This was primarily as the result of rising resource prices and emerging market boom in the international capital market. Except for few countries, however, there are still many countries that need to rely on the official external financing for meeting their development needs. In response to such needs, the industrial countries pledged to double their size of ODA at the Gleneagles Summit in 2005. Although the official flow to the developing countries (grants plus loans) was negative in 2005, this was primarily caused by the repayment (prepayment as well) to the IMF and bilateral creditors from the countries which suffered from the currency crisis in the late 1990's. "Net disbursements of ODA by OECD DAC member countries increased dramatically in 2005" according to the World Bank (2006). Behind this recovery particularly was the debt relief to Iraq and Nigeria, but "nevertheless, even excluding debt relief, ODA rose by 8.7 percent in real terms, up from a 5.6 percent average annual increase over 2002–04."

On the other hand, reflecting the improved capital flows to several developing countries as well as improving current account, there emerges a new group of nontraditional donors, such as China, India and Brazil. Capital flow from such emerging donors, especially directed to African countries and low-income Asian countries, is a new phenomenon and becomes increasingly important funding source for the poorer developing countries. These emerging donor countries are significant sources for FDI to the poorer developing countries, too. Such flow, while careful attention needs to be paid in their effectiveness of the project/program to be financed, is nevertheless welcomed additional resource for the low-income countries in pursuing their development goals.

In this way, the financial conditions of the developing countries are being greatly improved overall (at least, expected to be so) either by increasing private capital flows or traditional as well as nontraditional donor funding.

**b. Changing assistance modality in the donor flow**

With respect to the donor assistance modalities too, one changing trend has been observed recently. Multilateral donors as well as many OECD donor countries (especially European donors) extend a substantial amount of aid in the form of budget-support.

At the outset, some terms must be clearly defined. First, the characteristics of bilateral aid are defined by the Development Assistance Committee (DAC) as follows (OECD-DAC 2004, p. 40):

- *Project support* tends to identify a manageable set of problems and prescribe the inputs needed to foster local development. To contribute more significantly to poverty reduction, projects should be situated within the broader development framework, address the multiple concerns of the poor, and strengthen the capacities of the poor to achieve sustainable livelihoods.
- *Sector support* or *sector-wide approaches (SWAps)* contribute, under partner

government leadership, toward a single sector policy and expenditure program and should, where possible, use common management and reporting procedures to disburse and account for all funds. Sector programs imply a different approach to aid management, calling for greater modesty, an acceptance of a slow process of change, and partnership building.

- *Program aid* consists of financial contributions, not linked to specific project activities that are extended to a partner country for general development purposes, such as balance of payments support or general budget support. Program aid is often associated with the promotion of policy reforms at the macroeconomic level and/or in specific sectors.

Among the program aids, we can distinguish the *(General) Budget Support* and *Sector Budget Support*. *The Joint Evaluation of General Budget Support* (DFID 2005), in which the Japanese government and JBIC participate, defines budget support as follows:

- *Budget support* is channeled directly to partner governments using their own allocation, procurement, and accounting systems and is not linked to specific project activities. All types of budget support include a lump-sum transfer of foreign exchange; differences then arise on the extent of earmarking and on the levels and focus of the policy dialogue and conditionality.
- *Sector budget support* is distinguished from general budget support by being earmarked for a discrete sector or sectors, with any conditionality relating to these sectors. Additional sector reporting may augment normal government accounting, although the means of disbursement is also based upon government procedures.

The JBIC makes several types of ODA loans, both project-type loans and sector-targeted or program-based loans. To maximize the effectiveness of its assistance, the JBIC also has a technical assistance (TA) facility to complement project management efforts. But recently, there have been some arguments among the development partners that the budget support is a superior type of development aid compared with the project-type development aid.

The roles and practices expected of budget support are specified by the DAC as follows (OECD-DAC 2005):[5]

[5] It is sometimes criticized that these guidelines are not necessarily followed in actual practice and that the budget supports do not always contribute to the reduction of the associated transaction costs.

- Budget support should reinforce partner countries' ownership. When providing fungible resources in the form of budget support, donors should support a partner country's overall development policies and priorities. While this requirement raises a justifiable need to discuss budgetary goals (and related funds allocation decisions) with the partner government, sustained policy implementation ultimately depends upon strong political commitment. Budget support should therefore not attempt to leverage policy actions where such commitment does not exist.
- Budget support should help to enhance the performance and accountability of partner countries' public financial management (PFM) systems. Budget support provides donors with a legitimate interest in strengthening the PFM systems through which their funds are spent. For both developmental and fiduciary reasons, donors should use the provision of budget support to foster the improvement of partners' PFM systems, including transparency and accountability to their legislatures and civil society at large.
- Transaction costs incurred by budget support should be minimized. Channeling budget support through national procedures is a way to reduce transaction costs. Additional transaction costs associated with budget support, such as those incurred through multiple and large-scale PFM assessments, should be kept to a minimum.
- Budget support should be delivered in a way that enhances the predictability of resources and reduces their volatility. When planning their budgets, partner countries' authorities should be able to count on reliable estimates of the amount of budget support, the timing of its disbursement, and clear conditions for its release. Predictability is an important requirement for partner countries' budgetary authorities, particularly with respect to the short-term disbursements of committed aid and the early commitment of future aid flows in the medium term. Higher predictability and lower volatility facilitate the implementation of policies geared toward macroeconomic stabilization, the design (and implementation) of medium-term expenditure frameworks (MTEFs), the strategic allocations of funds across policy priorities, and the rational choice of the most cost-effective financing strategies. However, experience shows that the actual timing and size of budget support commitments and disbursements are variable. While this may be partly due to partner countries' behavior, donors should seek to eliminate the sources of volatility that are under their control.

While it is agreeable that the concerted efforts are required among recipients and donors to realize the above benefit, these are not guaranteed consequences of budget supports. The Japan's view is that, while the budget support is effective to some particular issues to be addressed, the *aid effectiveness* should not be mixed with the issue of *aid modalities*. Regardless whether the aid is extended in the form of project-aid or program-aid, sufficient care must be paid to the harmonization of procedures as well as the overall development policies. "There is no aid modality which is inferior or superior to other aid modalities. What is important is to choose the most appropriate modality of aid in response to the development needs, and the respect for the various modalities of aid is necessary" as Kitano (2006) argues.[6]

We will review the Japan's experience in Vietnam later, and will describe that Japan tried to realize the optimal mix of various aid modalities. But what was not fully discussed and explicitly agreed there was whether the usage of budget support funds matters on the long-term growth objective. As seen in the arguments by OECD, the usage of the fund is discussed mainly in the context of the fiduciary risk, i.e., to use the provided aid efficiently avoiding misuse or waste. It is not discussed, however, on what kind of expenditures the provided aid should be allocated to.[7] Even when the funds are used on programs appropriately targeted to benefit the poor in proper way, there could be particular types of usages which may harm the long-term objectives of the economic growth. Furthermore, the PEM (public expenditure management) which is supported to reduce the fiduciary risk will not aim to improve the private sector development directly. In discussing the aid effectiveness, whether to extend aid in the form of budget support or project support

---

[6] Another issue being discussed is the argument on grant vs. loan. The Japan's stance was that highly concessional ODA loans have four advantages for enhancing aid effectiveness (Ojima 2004):

- *Sustainability*. They can create incentives for appropriate aid management as they foster cost recovery mechanisms within the partner country government.
- *Continuity*. They support the seamless transformation of an economy from dependence on aid (100 percent grants) to dependence on the financial market (100 percent private funding).
- *Stability*. Those that are based on large multiyear commitments can mitigate the volatility and unpredictability of aid funds, helping to stabilize the partner government's budget process.
- *Ownership*. They can foster the ownership of the partner government, because each project is officially screened for its consistency with the government's policy.

[7] This does not mean that the associated fiscal framework disregards the expenditure side of the fiscal management. It *does* review the expenditure composition but mainly from the view point of whether "the poverty reduction expenditures"—mainly education and health—are appropriately allocated or not. The effect of the expenditure composition on the macroeconomic stability and growth as discussed in the IMF framework, however, is not addressed.

is not relevant. The contents of policy reforms supported in the programs (PRSCs and DPLs) should be more relevant.

### c. Risks associated with the substantial capital flow

Before going to the above discussion, we need to discuss the risks associated with the increasing availability of capital. There are numerous critical analyses in the academic literatures questioning the effect of aid flow on the welfare of the recipient countries.[8] Behind such question are the volatility/uncertainty of the aid flows and the risk of exchange rate appreciation. IMF and World Bank (2006) writes "while a number of studies find evidence that, on average, the net contribution of public investment to growth is positive, the robustness of most of these results is uncertain, and the direction of causality remain unclear. Even when the relationship is judged to be statistically significant, the estimated growth impact tends to be relatively small." (p 58)

On the contrary, the private capital flows are usually treated as unconditionally desirable, assuming that the private capital *should* naturally flow to the growth-enhancing and prudently screened sectors and projects, and, therefore, *should* not cause the debt distress.

The largest share of FDI recently flowing into the developing countries is, however, directed to the resource-extracting sector,[9] which is not labor-intensive to help income generation of the ordinary poor people. The concern on the exchange rate appreciation is applicable to the private capital too, and in addition, the resource exports financed by these investments may double the pressure on the exchange rate, and thereby the effect on the long-term economic growth (i.e., the resource curse).

Significant portfolio investment is another form of financial flow to the developing countries. But those portfolio capitals are quick in running away once the market sentiment turns to bearish, and carry a significant risk of volatility in the capital flows—could be

[8] In the academic literatures, the effect of ODA on economic growth is not confirmed statistically significant. However, the statistical test of *aggregate* ODA amount on economic growth may lose the difference in quality of projects. Unfortunately, there are cases of failed, sometimes politically motivated, projects which were not appropriately designed to support the economic growth in effective way.

[9] For example, the recent UNCTAD report writes "current FDI growth seems to be led primarily by a few specific industries, rather than being broad-based sectorally. Specifically, in 2005, oil and gas, utilities (e.g., telecommunications, energies), banking and real estate were the leading industries in terms of inward FDI. For the first time since 1987…, the petroleum (including oil and natural gas) industry became the largest FDI recipient, accounting for 14% of all cross-border M&A sales, followed by finance and telecommunications."

more volatile than the official aid.

Significant increase in the aid flows from emerging donors may cause another concern on the economic management.[10] Traditional donors usually require the policy improvement by recipient countries when they extend aid. The required policy improvement could be in the procurement policy, the environmental aspects of the project, or the fiscal management aspects. There could be an argument on the appropriateness of the policy changes advocated by donors, but such dialogues certainly help the recipient countries in developing the globally required institutional capacity. Emerging donors, however, do not attach such requirement when they extend finance.

In addition, the emerging donors do not always participate in the donors' coordination effort for the policy harmonization. Such approach, not only neglects the opportunity in the recipient countries' institutional development, but may even harm the traditional donors' coordinated efforts on the policy improvement.

Same thing could be pointed out in the size of the loan aid. Traditional donors, especially after the debt relief initiatives in the late 1990's, carefully monitor the debt situation of the recipient countries and adjust the size of the assistance package so as not to push the recipient countries to another risk of debt distress. Emerging donors' loan size, however, sometimes exceeds the appropriate level conceptually shared by the traditional donors—their assistance may be motivated primarily from the political consideration, including that of securing the natural resource.

In short, the question faced by the developing countries has become different in a significant way. The question in the past was "how the country can utilize the *limited* resources in the most efficient and effective way?" However, the question now (at least, for some countries) is "how the country can utilize the *abundant* amount of resources so as to minimize the risks on the macroeconomic stability and the long-term growth objective?"

## III. Policy Review Framework presented by the IMF

Japan's ODA has always been targeted to the objective of long-term economic growth although the goal of poverty and social development has not been neglected.[11] The

---

[10] Concern from the political context—some of the large recipients are not necessarily democratically governed—is another issue, but this is not discussed in this paper.

[11] Needless to say, this does not mean that the simple trickle-down effect was believed in its aid policy.

large portion of Japan's ODA, especially ODA loans, has been targeted to the infrastructure sectors. While ODA should play a certain role in the growth-enhancing economic policy, the vital private sector activity especially in the trade and investment sector is indispensable for the sustainable development and the resultant poverty reduction. Japan's ODA was extended on infrastructure development aiming to induce the private sector activities, especially FDI on manufacturing sectors inflow.[12]

For example, Kimura and Todo (2007) examined the effect of ODA on FDI by using the gravity model. Their approach is to construct the data set on the flows of ODA (separately for aid on infrastructure and non-infrastructure) and FDI by each pair of countries,[13] and estimated the gravity model equation for each pair. From this empirical study, they found that ODA in general does not have statistically significant impact (positive or negative) on FDI, however, Japan's infrastructure ODA has statistically significant impact on FDI from Japan.[14]

This basic strategy was maintained also in the case of budget support programs where Japan placed more emphasis on the trade and investment sector, as seen in the case study of Vietnam discussed later in this paper.

The well-formulated analytical framework which supports this strategy had been difficult to find until the framework was presented recently by the IMF.[15] The basic structure of the argument is summarized as follows:

---

[12] Again there are literatures critical to the role of infrastructure on attracting FDI. However, "Survey Report on Overseas Business Operations by Japanese Manufacturing Companies" which is annually conducted by JBIC always lists the lack of infrastructure as one of the most significant factors which hinder the FDI decision in many developing countries.

[13] Donor countries tested are Japan, U.S., U.K., France and Germany. Recipient/host countries are 29 countries. Of course, pairs cannot be constructed for all the country pairs since some pairs do not have either ODA or FDI relationship.

[14] According to them, the effect of ODA on FDI includes; (1) positive effect from the provision of public goods; (2) negative effect caused by the rent-seeking activity on ODA which harm the sound business competition; and (3) *vanguard* effect. The last one is the various information spill-over effects from the ODA operation to the business sector. For example, the business sector requires the necessary information on the level of skilled workers, bureaucrats, explicit/implicit business practices or government regulation and so on when they make the decision on FDI. Such information is hard to obtain unless they do the actual business in the host country. But when the firms conduct their business funded by ODA, they will be able to obtain such information. Such information spill-over to trigger the FDI decision is termed as *vanguard* effect. Their empirical study that Japan's ODA has the positive effect on the FDI from Japan but not from other countries may suggest the importance of this effect. The same effect is observed for U.K. although less significantly than Japan.

[15] For example, IMF (2005). Several policy papers along the same line have subsequently been published such as Gupta et al. (2006) and Heller et al. (2006).

- When a government receives the budgetary support from donors, the government usually uses this fund (foreign exchange) for the imports of essential commodities or for the domestic expenditure by selling the received foreign exchange to the central bank. In the latter case, the central bank may sell the foreign exchange to the market to accommodate the import needs of the public or not sell in order to accumulate the foreign reserves. The government may also opt for not using the fund and accumulate the fiscal reserves. In short, the government has the option to *spend* or *not to spend*,[16] and the central bank has the option to *absorb* or *not to absorb*.
- From the macroeconomic viewpoint, "spend and absorb" option is the best since it does not affect the inflation or the exchange rate appreciation. The option of "not spend nor absorb" is also appropriate from the macroeconomic viewpoint while the option of not using the received fund contradicts with the demand for the public goods by the general public. The option of "absorb but not spend" may be appropriate under the circumstances of high inflation and the lack of appropriate public investment projects. The existing domestic debt is replaced by the foreign exchange, which helps to lower the money supply growth. Finally, the option of "spend but not absorb" will generate the pressure on the inflation from the monetary expansion and the real appreciation on the exchange rate. The central bank, in the face of increasing inflationary pressure, should intervene to raise the interest rate, but this may lead to crowd out the private investment and, thereby, the long-term growth objective.
- However, the above worst option is likely caused from the different political and institutional motivation of the government and the central bank. Not to use the abundant aid flow is not a feasible option for the government from the political viewpoint.[17] On the other hand, the central bank has preference in accumulating foreign reserve in case for the external shock, rather than accommodating the import demand of the general public.
- Another aspect to be taken care of is the long-term fiscal sustainability. Especially when there is an uncertainty in the long-term aid availability, the medium-term fiscal framework to secure the stable fiscal policy path is required. The well

[16] "Spend" option includes using the fund for tax cut.

[17] The pressure from the donors may be another reason to prevent "not spend" option. The central banks face less pressure from donors to absorb aid.

managed debt strategy is necessary to limit the size of the borrowing for the debt sustainability, and in addition, care needs to be paid to the contents of the expenditure patterns too. For example, it is risky to use the aid fund on such programs which are difficult to cut back even when the aid funds will not be extended. Some type of social programs, such as education and health, a significant portion of which consist of recurrent expenditures including the wage payments to the teachers and doctors, cannot be curtailed in order to sustain the program effect. Once the program starts, the program must go on even when the donor aid will not be extended. The most effective measure against such capital flow vulnerability is to increase the domestic revenue as much as possible and to try to finance such programs with high contents of recurrent expenditures by its own revenue.

The above framework is a new approach trying to give another viewpoint on the fiscal management of the low-income countries under the new financial circumstances. Problem has changed from the traditional question, i.e., "how to utilize the limited resource wisely" to the new emerging question, i.e., "how to manage the significant inflow for sustainable economic management." Programs being supported under the MDGs are mostly spent on the domestic recurrent expenditures. In accordance with the above framework, such expenditure pattern will most likely be "spent but not absorbed," which will be the worst option from the macroeconomic viewpoint.

Some donors tend to have bias against the infrastructure and economic sectors. However, these economic sectors have several advantages from the above viewpoint. These programs, when implemented properly, have positive effect on the economic growth, and thereby the domestic tax revenue too. Typically, the import contents are high for infrastructure projects, making the funds *spent* and *absorbed*. In addition, capital expenditures are relatively easy to adjust their size in accordance with the surrounding economic and fiscal conditions. Once the projects are completed, the required subsequent expenditures are relatively limited only to the operation and maintenance expenditures.[18] The projects which remove the supply-side bottlenecks would also help to relax the inflationary pressures. Through the reduction of production costs and the improvement in

[18] It is true that many low-income countries lack the institutional capacity to raise revenues from the development projects. In order to support Vietnamese government, the donors coordinated to establish the fiscal framework integrating the investment budget and the operation and maintenance budget.

the productivity, the effect on the real exchange appreciation would also be mitigated.

From the above framework analysis, we can draw some conclusion on the appropriate policy choices under the circumstances of growing capital flow. *First*, the budget support aid should better be spent and absorbed. Project aid on economic infrastructure as well as emphasis on economic sector for program contents are such options. *Second*, in allocating the fiscal expenditures supported under the budget support programs, the government should not neglect the economic sectors which can help remove the supply bottlenecks of the economy. Other supporting measures to raise the supply responsiveness such as the business environment improvement to attract more foreign investment should better be accompanied. *Third*, in order to fund the social sectors continuously even without the donor support, the government should endeavor to raise its own domestic revenues. This can be achieved by the overall tax reform, but the development of infrastructure too can help raise the revenues when the utility charges can be collected. Needless to say, the overall economic growth will have positive effect on the revenue level.

## IV. Experience of Budget Support Program in Vietnam

In this section, we will review our experience in Vietnam and try to evaluate this experience in accordance with the above new framework.[19]

### a. Emphasis on the Infrastructure in the Poverty Reduction Strategy

From the mid-1990's, "the poverty reduction" has become the mainstream of the development objective among the international development communities, and the preparation of the Poverty Reduction Strategy has become required. Now it is widely acknowledged that the economic growth is a *necessary* condition for any meaningful and sustainable poverty reduction strategy. Until recently, however, the PRSPs prepared in various countries targeted the expansion of the basic social services, rather than the expansion of the economic services or the promotion of the private sector activities, including the foreign investment.

In Vietnam, the first PRSP—Comprehensive Poverty Reduction and Growth Strategy (CPRGS)—was prepared in 2002, but it largely ignored the importance of the role

[19] The joint effort among the Japanese government, JBIC and other development partners in the Vietnamese context is well summarized in Kitano (2006). Description especially in part **a.** and **b.** below owes much to this report.

of the sustainable economic growth through the infrastructure development in the process of the poverty reduction.

Japan—the Government of Japan, JBIC, JICA and JETRO—approached the Government of Vietnam (GOV) as well as the World Bank, trying to redirect the mainstream strategy to the economic growth—the improvement of investment environment; the promotion of small and medium scale industries and the private sector; the development of economic infrastructures (transportation, energy, and information communication); the human development to support the growth strategy; and the structural reforms such as state enterprise reform.

From the beginning, the GOV had a concern on the duality of the development strategy. GOV treated the CPRGS as a lower tier tool to realize the government's own five-year development plan, while the World Bank and other donors treated the CPRGS as an upper concept to replace the government's five year plan.[20] Once the CPRGS became operational since 2002, the conceptual gap between the GOV and the donors had widened, which raised the concern on the GOV's development policy implementation. Japan's role to coordinate the GOV and the donors to include the infrastructure development in CPRGS helped to reduce the gap between the five year plan and the CPRGS, eventually integrating the CPRGS into the five year plan.

This initiative was reflected in the policy framework of PRSCs. Japan (JBIC) started to co-finance with the PRSC program from the PRCS-3, and the policy matrix started to include the infrastructure sector from this program (See Box 1). Such approach eventually led to the review of the broad development strategies shared among the international development communities.

The dialogue among Japan, the World Bank and Asian Development Bank led to the joint research on the infrastructure, and the result was published in 2005 as "Connecting Asia." This joint study paved the way toward the development policy on *the return to the infrastructure,* and led to a wider, comprehensive perspective on the role of infrastructure.

Box 1. Policy reform, ODA and FDI in Vietnam

[20] This means that the PRSP process was not exercised under the full ownership of the Vietnamese government which contradicts the assumption to extend the budget support. However, during the consultation process in the later stage, such gap between the stakeholders was narrowed.

The World Bank extended a series of policy reform loans to Vietnam. The first PRSC was extended in 2001, subsequently followed by the successor programs as well as Development Policy Loans aiming at specific development sectors. One of the characteristics distinguishing the development programs in Vietnam from other countries experience was the specific focus on the economic growth, particularly on the infrastructure, in the overall development policies. To support this initiative, JBIC co-financed with the World Bank's policy credits starting from the PRSC-3.

PRSC-1 had six major sectors of policy reforms, namely (i) macroeconomic policy, (ii) private sector, (iii) SOEs reform, (iv) integrating with the world, (v) banking, and (vi) public spending. Policy actions required under "(ii) private sector" include removal of business license requirements; phase-out of dual pricing; and improvement of financial reporting and audit. Policy actions under "(vi) public spending" include improved budgetary transparency; adoption of direct funding mechanism to schools and health facilities for exempting fees of the poor; coordination between capital and recurrent expenditures; and creation of generous social safety net for SOE workers affected by the reform. As can be seen, the infrastructure development was not clearly covered in this policy matrix. (Of course, the World Bank extended support for infrastructure projects along with the PRSCs, and it is not fair to say that the Bank neglected the importance of the infrastructure development.)

But in the PRSC-3, "infrastructure" was explicitly included in the policy framework. One of the policy actions there was to "expand the CPRGS to address large-scale infrastructure." Its focus was on the quality of investment—the quantity was already one of the highest among the developing countries. In the subsequent PRSCs, the policy actions included the issuance of Electricity Law; creation of regulatory framework for network interconnection in telecommunications; and preparation of pilot MTEF for transport sector to better balance maintenance and capital expenditure.

Along with these budget support loans, JBIC extended a series of loans targeting the transport infrastructure projects in the northern Vietnam, such as National Highway No. 5 Project and Haiphong Port Rehabilitation Project. Traditionally, a significant portion of FDI into Vietnam concentrated in the Southern part of Vietnam where good business environment including infrastructure was already developed. In order to correct such regional imbalance, the GOV had a strong intention to develop infrastructure system in the northern Vietnam. According to the Independent Post-Evaluation on the above projects, the improved transportation in the suburb of Hanoi and Haiphong triggered large investments, especially Canon, followed by substantial number of parts industries. Policy reforms supported under the PRSCs such as the simplification of business procedures are another factor which backed the investment decision. Thus, the right combination of policy reforms and physical investment was behind the accumulation of private investment in Northern Vietnam.

FDI into the country expanded significantly for the recent years. On the approval basis, the total amount of FDI in 2006 reached US$10.2 billion, the highest level in the history. From Japan too, the number of FDI projects approved was 130 with the total investment amount US$940 million. This was the highest number of projects in the history, and the second highest amount of investment. What should be noteworthy is that the investment amount in the northern part is recently greater than those in the southern part of the country. Several factors are pointed out behind such trend, including the development of large industrial estates in the suburb of Hanoi and the easiness in hiring low wage employments. But the development of good infrastructure in the northern part could explain at least a part of this development. Even currently, the lack of infrastructure development is pointed as the most important impediments for the Japanese firms to expand their business in Vietnam.

**b. Joint Initiative for Improvement in Investment Environment**

The role of promoting the trade and investment in the real economy is among the most important role played by the ODA. Especially under the current international circumstances of progressive globalization, where the global or regional competition beyond the border becomes intensive, the promotion of foreign direct investment, not in the resource extracting sector, is indispensable in initiating and sustaining the dynamic economic growth as shown in the experience of China. How Japan can help the improvement of investment environment through the provision of various forms of ODA in the neighboring countries such as Vietnam was a big task given to the Japanese ODA and diplomatic policy.

The lack of proper investment climate was well recognized by the GOV, major donors, and the private sector. The factors behind include overly rigid investment regulations, non-transparent tax and customs administration, lack of protection of intellectual property rights, widespread corruption, inconsistency between laws, and lack of infrastructure and the resultant high utility cost. Japanese business forum felt seriously unsatisfied with the Vietnamese investment environment, which called for the joint public-private approach to its improvement.

In response to such calls, Japan established the *Joint Initiative between Vietnam and Japan for the Improvement of Investment Environment* with the support by top political figures of two governments, where the joint action plan was prepared to each area which needs to be improved. From the Japanese side, not only the government institutions but also the private business sectors (Nippon Keidanren) participated in this process, and the subsequent actions were supported by the various ODA instruments.[21]

This approach undertaken in Vietnam—various ODA instruments were mobilized in order to attain the goals of improvement of investment environment—were an effective

[21] The Action Plan, prepared in December 2003, listed 125 sub-items under 44 grand items which were committed for the necessary actions. As of end 2005 at the review point after two year follow-up period, 105 items (85 percent) were classified as satisfactorily implemented (46 “completed” and 59 “progress as scheduled”).

model case to pursue the strategic ODA system to reflect the national interest of the both Vietnam and Japan. As a result, the close collaboration between the ODA and the business sector was achieved, and the subsequent increase of Japanese investment in Vietnam.

### c. Aid Coordination and Harmonization in Vietnam

As discussed in Section III, the project-type approach involves the issue of high transaction costs, which need to be rectified in the process of donor harmonization. Some argues that the project aid needs to be replaced by program aid on this ground, but the harmonization (effectiveness) can be enhanced through the project aid too. In this sub-section, we describe the results of such aid coordination and harmonization in Vietnam mainly from the viewpoint of the Japanese government–JBIC.

Box 2 outlines the chronological efforts to harmonize aid and enhance its effectiveness in Vietnam, in association with the commitment of the Japanese government–JBIC to the CPRGS development process.

The five banks' initiative described in Box 2 was primarily launched on the assumption that harmonization (integration of the five banks' systems with the country systems of Vietnam) for financial management and safeguard policies could be realized first at the project level.

The prime example of accelerating policy reform through individual projects under the five banks' initiative was the improvement of public procurement systems. Vietnam's donor countries accepted, with certain conditions, the draft standard documents for local competitive bidding (LCB) that had been prepared under the current framework (Procurement Ordinance #88/66) for the procurement reforms initiated by the Vietnamese government. At the same time, as discussions were in progress on redrafting the LCB standard documents for use in the country's overall procurement system, the five banks also continuously sought improvement (from a medium-term perspective) in the course of developing the government's new procurement ordinance. JICA also contributed significant TA for capacity building in public expenditure management. This was a notable collaborative contribution by the Japanese government as a whole, in addition to the harmonization process among the donor community.

Box 2. Aid Enhancement Efforts in Vietnam

*Before May 2002*
Vietnam requested harmonization through Joint Portfolio Performance Review (JPPR), separately from international discussions.
*May 2002 (Interim Consultative Group) to February 2003 (Rome Declaration)*
In the wake of an approach by the World Bank, three banks (the World Bank, Asian Development Bank, and JBIC) agreed on the three areas of procurement, financial management, and environment in the harmonization action plan.
*February 2003 (Rome Declaration) to December 2003 (Harmonization Action Plan)*
Two more banks, Agence Française de Développement (AFD) and Kreditanstalt für Wiederaufbau (KfW), joined the project in May 2003. The JPPR was implemented. During this period, an initiative for harmonization was developed throughout Vietnam. Vietnam proposed the issues of harmonizing harmonization and aid modalities (including financial aid and migration) to sectorwide approaches.
*December 2003–February 2005*
Group on Aid Effectiveness (GAE) was established.

Based on the experience of the five banks, in procurement, for instance, the JBIC presented the view that harmonization only among donor countries or harmonization of ODA-related projects would not lead to solutions, but that it is much more essential to improve public investment systems developed by the governments of partner countries. (If they were improved, donor countries would be able to fully utilize the systems of the partner country.)
The issue of country systems presented by the World Bank and the importance of building capacity were integrated.
A mutual understanding between Vietnam and donors was promoted from the view that improvement in overall management of development funds would be necessary and that utilization of country systems would not be viable without capacity building.
The Vietnamese government identified two main headings and contents of activities of local projects in Vietnam:
• reinforcement of procurement systems → capacity building
• Intensification of PFM → development of MTEF, PFM Intensification Project, integration of reporting systems for ODA projects.

Japanese government–JBIC efforts to PRSC3 assistance can be summarized as follows:
• *Focus on public expenditure management and improvement of business and investment environments:* The proposals by Japan were reflected in the policy matrix. The Japan-Vietnam Joint Initiative Action Plan was reflected in the matrix for improvement of business and investment environments in April 2003.
• *Improvement of business and investment environments:* This was based on the awareness of the problem that foreign capital investments were not advanced due to regulations regarding foreign capital, flaws in fundamental rules and administration, lack of support industries, and other underdevelopment factors in the investment environment.
• *Public spending management:* For implementation of individual infrastructure development and

enhancement of public spending efficiency, pursuit of consistency between investment budget and ordinary budget, appropriate examination of public investment programs, and establishment of evaluation frameworks were included as future tasks. The chapter for the roles of large-scale infrastructure in poverty reduction was added to the CPRGS as proposed by Japanese government–JBIC.

The above comparison yields two major findings:

- The experiences and the clear and well-defined targets at the project level through reinforcement of procurement systems have led to hands-on capacity building and the establishment of comprehensive country systems at the national level.
- Standardizing the use of country systems in the implementation of ODA projects has created incentives to implement necessary policy reforms under the budget support framework.

These findings suggest four lessons with regard to enhancing aid effectiveness through harmonization:

*(1) Importance of Short-Term Outcomes*

- Prompt production of tangible outcomes in the short term is important because it will encourage both partner countries and donors to make progress toward harmonization.
- To this end, donors should harmonize those of their methods and processes that differ unnecessarily. Also, harmonization and simplification should be implemented at an early stage in the areas where both donors and partner countries can implement harmonization and simplification easily and effectively reduce administrative costs.

*(2) Cost of Harmonization*

- Because harmonization requires coordination among different organizations within both the donor and partner countries, it tends to raise administrative costs. Therefore the efficient and cost-effective processing of harmonization is critical.

*(3) Areas of Harmonization*

- While procedures must be simplified to reduce partner countries' administrative costs and harmonize aid, safeguard policies and transparency must meet international standards. The task is to provide a method to fulfill these two requirements simultaneously. But the areas where both are easily fulfilled are limited.

*(4) Consistency with Partner Country Systems*

- Adoption of higher standards for ODA-funded activities than those for domestic operations is not always sustainable.
- Harmonization in ODA may enhance operational efficiency and reduce processing costs, but entrenched differences in rules and methods between domestic operations and ODA operations may push up the administrative costs of the partner countries.

**d. Evaluation of Japan's ODA Strategy**

As we have seen, Japan's ODA strategy in Vietnam had strong emphasis on the economic growth of the country, especially the role of the public sector in infrastructure development. The importance of the state enterprise reform, the improvement of legal and regulatory system, or the corporate tax reform—as have been supported traditionally in the policy reform process—cannot be overemphasized. The private sector business, however, cannot be expanded unless the *physical* business environment, i.e., the infrastructural development, is not accompanied. Japan tried to coordinate donor communities to redirect the development policy dialogue to cover the importance of infrastructure.

Japan, along with extending the budgetary support in the form of co-financing with the PRSCs as well as DPLs, supported substantial economic sector projects, and these project aids were supplemented by the effort on the harmonization of the procedures and policies.

In accordance with the policy framework developed by the IMF, concentration to the social sector programs may have risks in macroeconomic management because of its likely nature of "spend but not absorb." Also, the emphasis on the economic sector either through the project aids or through the policy reforms accompanied with the budget support programs would improve the supply response of the recipient country. Project aid itself is a type of aid to guarantee "spend and absorb" option of the usage of aid money. And the infrastructure support induced the direct investment either through the direct effect on infrastructure service improvement or "vanguard" effect. Such large infrastructure development generally requires the imported goods which are not competitive with the domestic market demand.

In short, the strategy Japan adopted in the development framework of Vietnam exactly followed the policy recommendation recently developed by the IMF.[22] We cannot claim that the current economic advance of Vietnam was brought about solely by such ODA strategy, but it may be fair to say that at least partly attributable to the dialogue by the donor communities.

TABLE 2. Issues of Macroeconomic Management and JBIC Loans

| Challenge of economic management | JBIC's loan program |
|---|---|
| Aid fund should be spent and absorbed to avoid inflationary and appreciation pressure. | Most JBIC loans are extended in the form of project aid. Except for certain portion to be locally spent, project aid will be spent and absorbed. |
| Expenditure needs to be allocated to those items not competing with the domestic demand to avoid inflationary pressure. | Infrastructure projects require relatively high import contents for commodities and services which are not locally available. Expenditures on these items generally do not compete with the local demand, and consequently do not have inflationary pressure. |
| Expenditure to programs with less flexibility should be avoided. | Capital expenditures are relatively easy to adjust in accordance with the funding (although it is not desirable to discretionarily adjust the construction pace.) Once the projects are completed, the subsequent expenditures are relatively small for operation and maintenance. |
| Improve the supply response of the economy to mitigate the inflationary pressure. | Most investors find the lack of appropriate infrastructure services as one of the most serious impediments in starting their business. Promotion of private business through infrastructure projects will improve the supply response of the economy. *Vanguard* effect could be another factor which promote FDI and thereby the supply side response. |
| Enhance the government revenue for the sustainable funding of social programs | Although the tax reform and the tax administration reform should not be neglected, the economic growth itself has the revenue enhancing effect. Also the well-designed utility projects can add another source of public revenue in the form of user charge. |

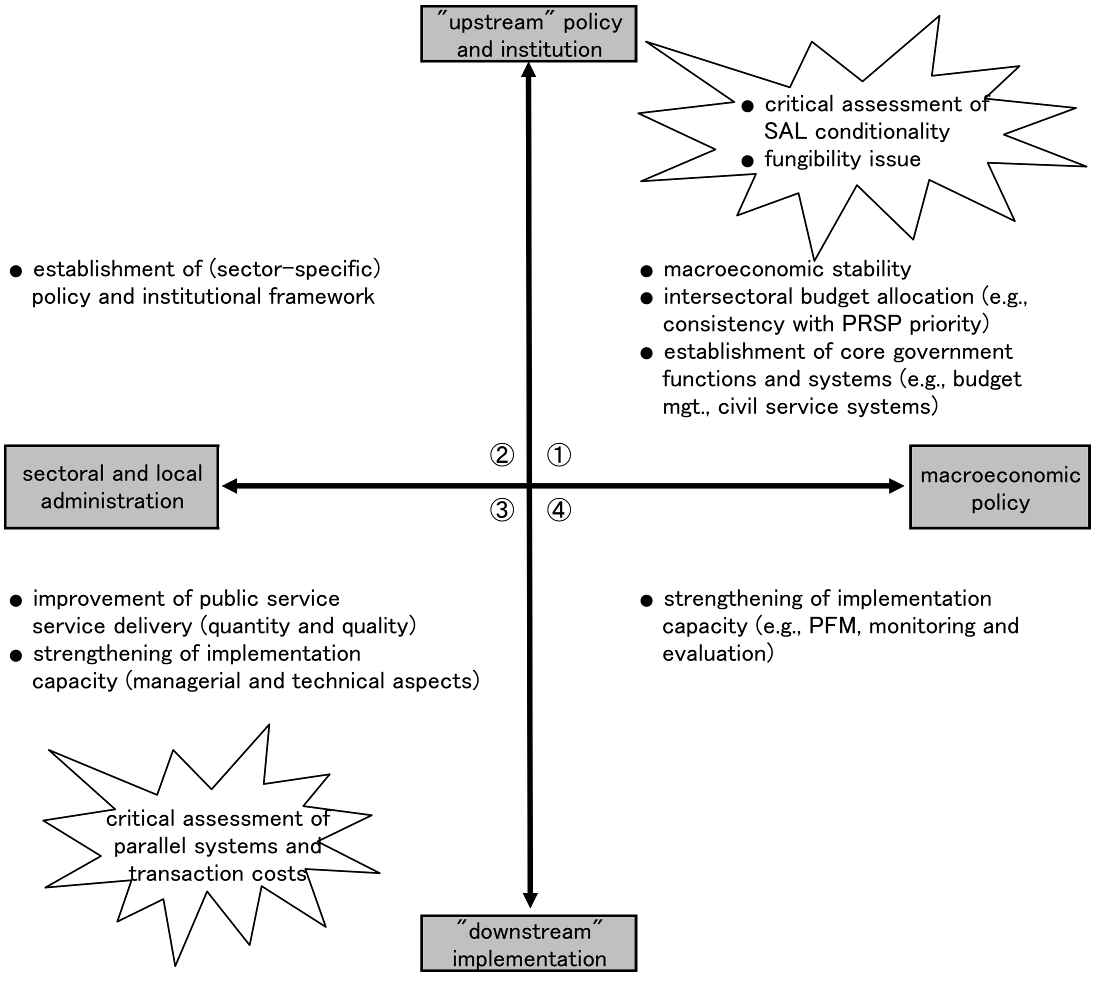
## V. Selection of Aid Modalities

The question arises whether budget support is a panacea to any country or not. We look at the experience of two countries, Tanzania and Vietnam, to compare the different roles that budget support assistance has played.

[22] Of course, the IMF framework is mainly directed to the low-income countries where a significant portion of budget is financed by aid flows. In the case of Vietnam where the aid inflows represent relatively small percentage of overall budget, the validity of the policy may not be as significant.

How can a country efficiently and effectively use the various aid modalities, including budget support, to address its development agenda? Ohno and Niiya (2005) developed a development policy matrix as a tool for specifying the relationships between aid modalities and development agendas (Figure 1). The matrix can indicate the position of certain project or a program on the Y axis, representing policy and institutional level versus project implementation level, as well as on the X axis, representing macroeconomic policy versus sector and local administration.

Figure 1. Development Policy Matrix



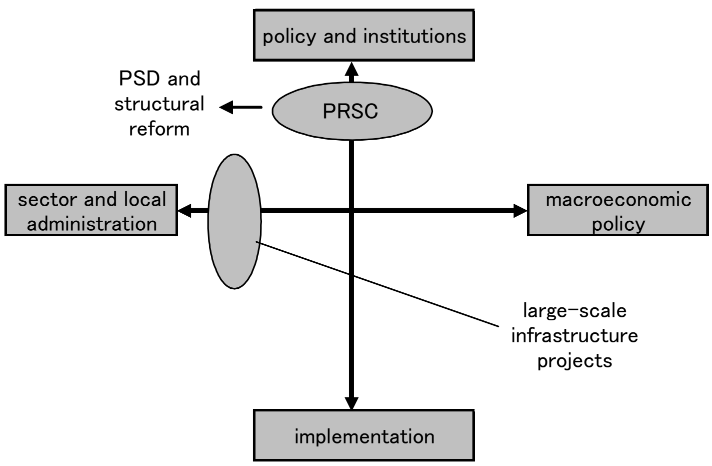

Source: Ohno and Niiya (2005)

As regards the selection of aid modalities and the need to control administrative costs, Japanese government–JBIC's harmonization experience suggests the importance of the following (Ohno and Niiya 2005):

- country-specific approaches that respect the ownership and leadership of the partner country;
- respect for the diversity of aid modalities;
- respect for capacity building and participation of civil societies; and
- no a priori preference for specific modalities.

In Vietnam, budget support (in the form of PRSCs) significantly affects policies and systems, and individual infrastructure projects also affect policies and systems through project implementation (Fig. 2). In addition, the conditions attached to budget support affect the mobilization of private resources for each sector and the structural reforms of the financial sector.

Figure 2 Vietnam: Effects of Different Aid Modalities on Policies and Systems




Vietnam: general budget support (PRSC) and infrastructure projects

- General budget support is designated to (a) promote policy and structural reforms for private sector development and (b) complement the investments in infrastructure projects.
- Low aid dependence.
- Weak linkage among PRSP, budget allocation, and performance monitoring (absence of MTEF)
- Broad but restrained partnership. Limited introduction of new aid.

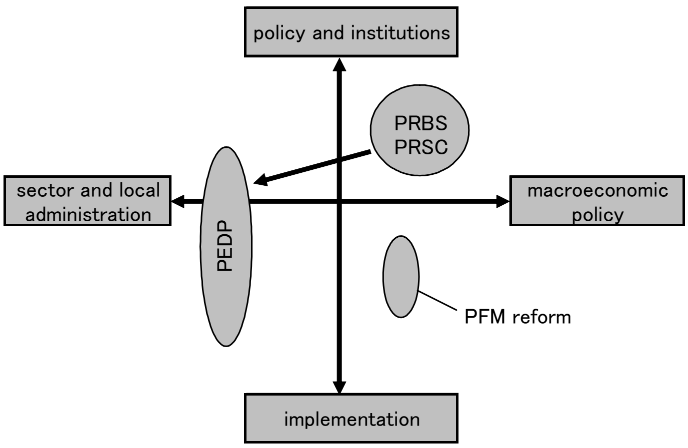
Source: Ohno and Niiya (2005)

Vietnam's experience also shows that project assistance and budget support (PRSCs) can complement each other. While PRSCs support the improvement of institutional frameworks, project loans provide replicability at the micro level to individual projects.

In this context, one could argue that the JBIC's ODA loans incur extensive transaction costs, considering that the average project is quite large in both physical and money terms. The costs of learning by doing should be regarded as constructive investment in human resources, but needless to say, minimizing the administrative costs of the JBIC's projects is important in general.

In Tanzania, priority is placed on general budget support and pooled finance. In this case, project assistance (small-scale) has comparative advantage, as long as such assistance is on budget and therefore aligned to Tanzania's development strategies (Fig. 3).

Figure 3 Tanzania: Effects of Different Aid Modalities on Policies and Systems




Tanzania: general budget support (PRSC/PRBS) and primary education SWAp (PEDP)

- General budget support and SWAp intende to address (a) macroeconomic policy and institutional framework and (b) the implementation of priority sector reform (e.g., budget allocation, quantitative expansion of social service delivery).
- High aid dependence.
- Shared understanding between recipient and donors of the problem of transaction cost and aid fragmentation.
- PRSP-MTEF-PAF linkage established
- Open and extensive partnership, active introduction of new aid modalities

Source: Ohno and Niiya (2005)

### Box 2. Comparison between Vietnam and Tanzania

In Tanzania in 2003, aid accounted for 75 percent of government spending, about 14 percent of GDP, and more than 80 percent of investment (Ohno and Niiya 2005). Tanzania has received debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative, and thus efficient aid management is a critical component of its fiscal management. Private sector finance is still only a small share of Tanzania's economy. Though historically stand-alone/off-budget/in-kind assistance prevailed, Tanzania's approach since the introduction of the national poverty reduction strategy has been to (1) channel aid in accordance with the priorities outlined in the poverty reduction strategy paper (PRSP), (2) harmonize donor procedures with its own government systems, and (3) channel aid increasingly through program aid, particularly general budget support (Ohno and Niiya 2005). Now Tanzania is often cited as a model of donor-government partnership. The important characteristic of general budget support in Tanzania is that it supports the government's budget implementation process directly, along with SWAps in important social sector programs.

In Vietnam, we see a different picture. Aid in 2003 accounted for about 18 percent of government spending, about 5 percent of GDP, and about 15 percent of investment. Vietnam has not applied for HIPC debt relief. Private sector development is the priority agenda for the transition to a market economy. A specific line ministry coordinates the overall development budget, and thus development planning, promotion of foreign direct investment, and aid coordination are led by strong government ownership. Three-fourths of the total aid to Vietnam comes from the World Bank, Asian Development Bank, and Japanese government–JBIC, and since large-scale project assistance constitutes a major share of aid, procedural harmonization among donors has advanced and transaction costs are relatively low. Project assistance dominates Vietnam's development effort, and budget support functions as a complementary tool to disseminate and replicate concrete outcomes from individual project assistance toward the achievement of growth-oriented structural reform processes (Ohno and Niiya 2005).

The above comparison shows that the role and significance of budget support differs between Tanzania and Vietnam because of the differences between the two countries' development agendas, including foreign aid management reflecting their aid dependency. It is also important to note that in Vietnam, the Comprehensive Poverty Reduction and Growth Strategy (CPRGS) is growth oriented (Ohno 2002), and thus the country's development agenda and programs have been supplemented with budget support.

Here we can draw some lessons from the above studies.

*From Projects to the National Level*

The experience in East Asia emphasizes the need for:

- a balanced response to conflicting demands, such as simplification of ODA project procedures and introduction of international standards for improvement of transparency, and
- strong respect for ownership by the governments of partner countries.

Both of the above lessons have been applied in the JBIC's ODA lending at the project level. The experience suggests that ODA loans will lead to capacity building at the national level as well as to the establishment of comprehensive country systems. Standardizing the use of the country system through the implementation of projects will automatically provide an incentive to partner country governments to accelerate the reforms that they encourage through budget support.

The harmonization process in East Asia does not merely seek efficiency in ODA projects and speed in ODA disbursements. It has also been implemented to assist the capacity development of partner countries, for example, improving the overall public expenditure system and replicating the best practices learned under ODA projects.

As seen from the examples above, "good projects" are premised on respect for ownership by the governments of the partner countries, consistency with the development plans of the countries and their domestic projects, investment/maintenance costs that are within budget, and effective replication of institution building. The effects expected from these "good projects" may be similar to the four effects expected from budget support that were outlined above (OECD-DAC 2005). The JBIC considers that budget support can be an effective tool for supporting such good projects.

Therefore a comparison between preferable characteristics of budget support and the JBIC's modality of assistance through project-type loans and program-based loans can be summarized as in Table 3.

Swift transfer of aid resources from donors to partner countries is not a sufficient condition for enhancing aid effectiveness. As long as the ODA funds transferred are converted into services and delivered to the beneficiaries through the public expenditure system of the partner countries, the efficiency of the entire public disbursement system of the partner countries may be more important than the facilitation of fund transfers to the partner countries.

From a mid- and long-term perspective, donors should support the development of human resources and institutional capacity in the partner countries and encourage the greater use of countries' own systems in channeling ODA. These processes should be implemented at a pace appropriate to the administrative capacity of the partner countries as well as the readiness and flexibility of the society to accept changes, according to their degree of ownership.

TABLE 3 Achieving the Goals of Budget Support through Project and Program Lending

| Preferable characteristics of budget support | JBIC's assistance in East Asia<br>(The project loans and program loans) |
|---|---|
| On budget; partner country's ownership | Yes (single line ministry, relatively small number of major donors) |
| Alignment to partner country's policy and practice | Yes (PRSP, programmatic approach, use of improved country systems) |
| Enhance the performance and accountability of partner country's PFM systems | Yes (harmonization among donors, use of improved country systems) |
| Reduced transaction cost | Yes (harmonization among donors, use of improved country systems) |
| Predictability of aid | Yes (multiyear commitment and disbursement) |

*Need for Customization of Project and Program Assistance*

No single model exists for enhancing aid effectiveness. A major premise is that aid should respond to local characteristics, historical politics/economics/social structure, donor structure, and the historical reality of aid acceptance. Based on these features, it is important to improve the budget expenditure system, which enables efficient distribution of aid funds, so as to engender synergy through the effective use of aid modalities.

## VI. Conclusion—Implication on Way Forward

What does East Asia's experience imply for future assistance to Africa?

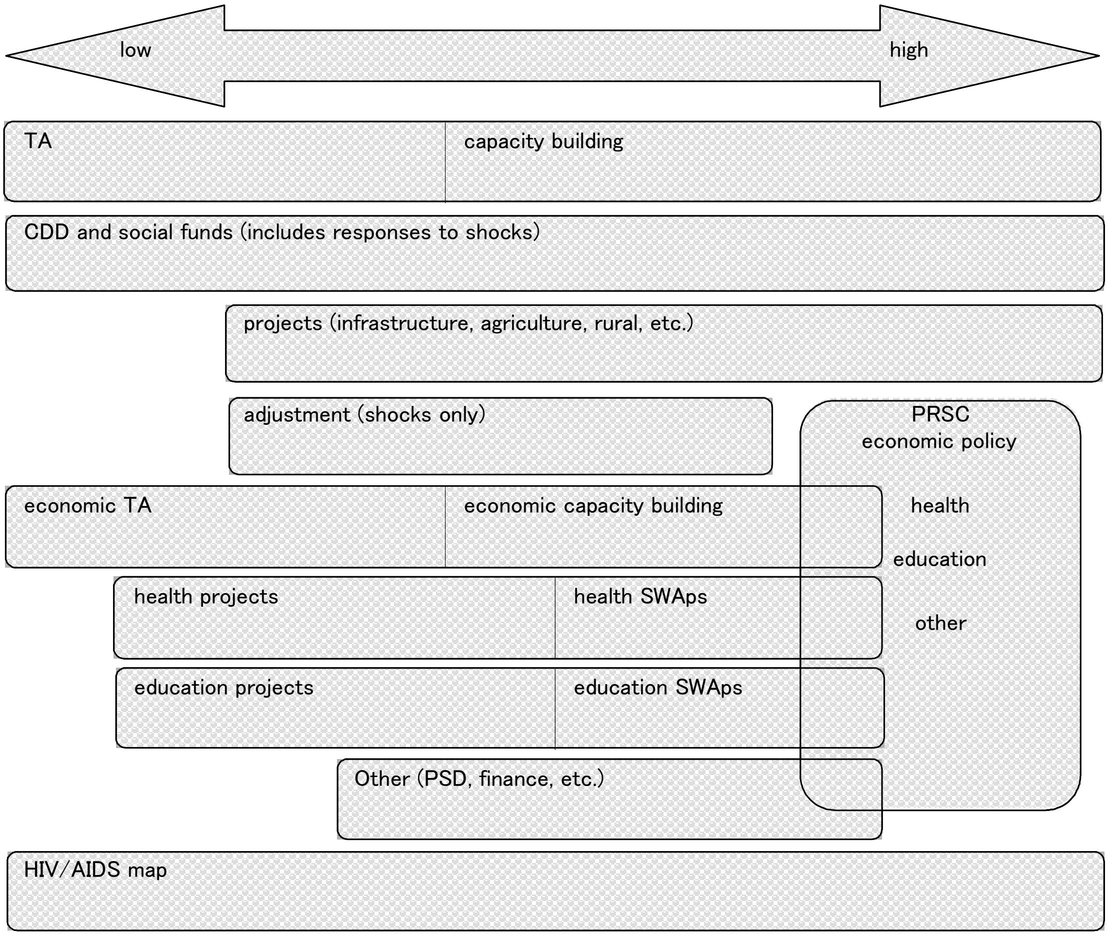
The choice and sequencing of aid modalities should cater to the country's priority development agenda. The significance and appropriateness of budget support to Africa should be assessed based on political/economical/social conditions and the environment that is fostered by the use of country-by-country approaches. Development will be a mid- and long-term continuous process involving economic and social changes in the partner countries. Thus it will be essential to respond from a mid- and long-term perspective, based on changes in development needs of the partner countries. Such dialogues will only be achieved through the long-term relationship between the recipient country and the donors. Alignment of partner country's systems, for example the procurement system, requires long and complex process, which is made possible only with the building of trust between the recipients and donors through the long-term relationship and dialogues, preferably from the beginning of the planning stage.

Facilitation of fund transfer mechanisms is necessary but not sufficient for aid effectiveness. Ways should be explored to improve the overall public expenditure system (planning system, procurement system, integration of capital expenditure and current expenditure, project evaluation and selection, budget management, individual project management). Experience with the use of various frameworks such as PRSCs, portfolio performance review, and harmonization of procurement procedure can be applied.

Development is not a linear process from aid dependence to dependence on the market. The viewpoint that the ultimate goal is to free the partner country of dependence on aid is an important one, and very relevant in the ongoing debate on budget support and aid modalities. And the extent to which the priority problems of partner country governments can successfully be addressed by public expenditures and policies (such as primary education and health issues), rather than by private sector activities, is a critical point to begin with. Pro-poor growth requires growth promotion and development of private agriculture, industry, and business, for which both public actions and the behavior of private agents such as firms and farmers matter. The importance of economic growth through private sector development cannot be overemphasized. Moreover, to foster productivity and thereby accomplish the Millennium Development Goals and alleviate poverty in Africa, the creation of network infrastructure, agricultural development, private sector development, and improvement in the investment environment are critical.

In this connection, the Strategic Framework for Assistance to Africa of the World Bank–IDA (Fig. 4) is promising for identifying good projects in future assistance to Africa. It is based on the premise of various aid modalities dependent on the partner country policy/system and reflects lessons from past assistance for structural adjustment.

Figure 4. World Bank–IDA Strategic Framework for Assistance to Africa




Source: World Bank (2004)

An efficient aid environment needs to be built to promote good projects, recognizing that private sector development and investment need to play a key role. The weight of each aid modality will also naturally change depending on country circumstances.

For Tanzania, as seen above, the Japanese government and JICA have been providing assistance to the first-generation poverty reduction budget support (PRBS) process with a combination of approaches according to the progress of its funding, that is, participation in forming a poverty reduction strategy system to execute the PRBS and a sector-wide approach to aid in the agricultural sector. Now the Tanzanian government and donors (including Japan) are establishing a second-generation PRBS framework, which puts more emphasis on growth aspects. The first-generation (social sector–oriented) PRBS is being transformed into the second-generation (growth–oriented) PRBS in accordance with Tanzania's current developmental needs.

Within the framework of Figure 4, then, Tanzania's position will shift further to the right. The key element is whether the shift reflects a growth-oriented process or not. The shift seems to be similar to the above-mentioned process in East Asia. Also, a critical view of the World Bank–IDA framework indicates that the issue of repositioning budget support will acquire major significance as the development process becomes growth–oriented.

Last, sufficient time and patience are required to achieve concrete development results. The following remark from a partner country seems to sums up the essence of the overall endeavor of achieving aid effectiveness (Duong 2005):

> Since the reforms of the country system would have significant effect not only on ODA-related stakeholders but on a full range of others as well, the recipient government's strong ownership and leadership is essential. Reforms may take a long time, but their impact would be much greater than any impact gained from establishing a dual system. Respecting the government's ownership and self-determination, a patient approach is necessary in implementing or supporting these capacity developments.

**References:**

Akiyama, T., and T. Nakao, (2005), "Japanese ODA – Adapting to the Issues and Challenges of the New Aid Environment" FASID Discussion Paper on Development Assistance No.8

Arakawa, H., (2006), "Budget Support and Aid Effectiveness: Experience in East Asia" in *Budget Support as More Effective Aid?—Recent Experiences and Emerging Lessons*, World Bank

Asian Development Bank/Japan Bank for International Cooperation/World Bank, (2005), "Aid Effectiveness in East Asia—Joint Efforts of Partner Countries, Asian Development Bank, Japan Bank for International Cooperation and the World Bank." Distributed at the Second High-level Forum on Aid Effectiveness, February 28–March 2, 2005, Paris, France.

Department for International Development, UK (DFID), (2005), *Joint Evaluation of General Budget Support 1994–2004 – Inception Report* London: DFID

Duong Duc Ung (2005). "Vietnam's Experience in Strengthening Procurement and Public Financial Management Systems in Harmonization, Alignment, and Capacity Development." Presented at the Second High-level Forum on Aid Effectiveness, February 28–March 2, 2005, Paris, France

Gupta, S., R. Powell, and Y. Yang, (2006), *Macroeconomic Challenges of Scaling Up Aid to Africa, A Checklist for Practitioners*, International Monetary Fund

Heller, P., M. Katz, Z. Debrun, T. Thomas, T. Koranchelian, and I. Adenauer, (2006), *Making Fiscal Space Happen! Managing Fiscal Policy in a World of Scaled-Up Aid*

IMF, (2005), *The Macroeconomics of Managing Increased Aid Inflows: Experiences of Low-Income Countries and Policy Implication*, IMF

IMF and World Bank (2006), Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief

Japan Bank for International Cooperation, (2005), "Medium-term Strategy for Overseas Economic Cooperation Operations by the Japan Bank for International Cooperation, April 2005."

Johnston, D., and R. Manning, (2005), *Doing Aid Better—A Comment Piece. Paris*: Organization for Economic Cooperation and Development

Kitano, M., (2006), *Strategizing the Japan's ODA—Japan's Action in Vietnam*, GRIPS Development Forum

Kimura, H., and Y. Todo, (2007), "Is Aid the Vanguard for the Direct Investment? – An Estimate through the Gravity Model," RIETI Discussion Paper Series 07-J-003

Ohno, I., and Y. Niiya, (2005), *Good Donorship and the Choice of Aid Modalities – Matching Aid with Country Needs and Ownership*. Tokyo: GRIPS Development Forum

Ohno, I., (2002). *Diversifying PRSP—The Vietnamese Model for Growth-oriented Poverty Reduction*. (October.) Tokyo: National Graduate Institute for Policy Studies (GRIPS)

Ojima, Y. (2004) “Emerging Issues in Development Finance,” *Traffic Engineering 39, Special Issue*, November. Tokyo

Organization for Economic Cooperation and Development, (1992), *Development Assistance Manual—DAC Principles for Effective Aid*. Paris: OECD High-level Forum (2005), “Paris Declaration on Aid Effectiveness: Ownership, Harmonization, Alignment, Results, and Mutual Accountability.” Paris: Organization for Economic Cooperation and Development

Organization for Economic Cooperation and Development – Development Assistance Committee (OECD-DAC) (2004) *Managing Aid: Practices of DAC Member Countries*. DCD/DAC (2004) 40, Paris: OECD

Organization for Economic Cooperation and Development – Development Assistance Committee (OECD-DAC) (2005) *Harmonizing Donor Practices for Effective Aid Delivery: Volume 2: Budget Support, Sector-wide Approaches, and Capacity Development in Public Financial Management*. A DAC Reference Document, DAC Guidelines and Reference Series, Paris: OECD

Ozeki, U., (2004). “Program-based Approach Programs and Growth in Vietnam and Ghana—A Note on Comparative Policy Issues.” June 12, 2004, compiled with notes for the presentation made by the author at LENPA Forum, June 1–3 in Tokyo, Japan, on “Program-based Approach in Asia—Adapting to Diversity.”

UNCTAD (2006), World Investment Report 2006, United Nations

World Bank/International Development Association, (2004). *Strategic Framework for Assistance to Africa: IDA and the Emerging Partnership Model*. Washington, D.C.: World Bank

World Bank (2006), *Global Development Finance 2006*, World Bank