Overview

A successful aid program requires matching elements of development strategy, appropriate aid strategy supported by well-designed modalities and effective implementation.

Aid Modality:

An instrument that transfers aid from donors to recipients

Outline of the Presentation:

- Economic rationale of Aid
- Economic rationale behind aid modalities
- Aid effectiveness and aid modalities
- Choice of aid modality

Overall:

Help put PBL in a broader perspective
What is foreign aid?

Aid

- Transfer of money, goods, and knowledge from donors to recipient countries
- Concessionary (25% grant) capital flows from donors to recipient countries

Aid vs. commercial capital flows

Official Development Assistance (ODA)

- Concessionary resource flows from donors to recipient governments

Effective development Assistance (EDA)

- Grants and grant equivalent of loans
Why foreign aid?

Supply Side Motives
- **Altruistic**: Humanitarian, crisis, developmental motives (global public good), resource availability
- **Non-altruistic**: Foreign policy and commercial motives

Demand Side Motives
Recipient countries need money, goods, and knowledge but unable to finance due to local and international market imperfections:

**Development Bank Paradigm**
- Information asymmetry in capital markets
- Many good projects have:
  - Long gestation periods
  - Heavy sunk costs
  - Social benefits occur far in the future
- High risk for commercial lenders
- Commercial capital flows end-up in few countries
Evolution of Developmental/ Aid Paradigms

Aid/ Development Thoughts in 1950s and 1960s

- Marshall plan
- Big – push
- The gap models
- Income distribution, basic needs
Evolution of Developmental/ Aid Paradigms

Aid/ Development Thoughts in 1990s

End of Cold War: Geopolitical and foreign policy motives no longer mattered
Altruistic goals occupy center stage.

Post-Cold War empirical evidence - “No effect of aid on growth”
- Inconclusive evidence of the 1980s

Disappointing growth outcomes of the first generation
conditionality-based structural adjustment initiatives in the 1980s

Continued misery and destitution in aid-dependent Sub-Saharan Africa

Growing demand for “participation” and inclusion, by NGOs
Evolution of Developmental/ Aid Paradigms

Aid/ Development Thoughts in 1990s

Growing claim that “poverty reduction” was being marginalized by too much focus on growth

Poor coordination among donors - Taxing the capacities of LDCs and diffused aid delivery.

New empirical results - effective aid conditioned on good macroeconomic environment.

Institutional Deficit and Rule of Law - Governance
Evolution of Developmental/Aid Paradigms

**New Aid Paradigm (NAP)** how aid is delivered is as important as the aid itself.

DAC (1996) proposed the international development goals:

- local ownership
- partnership

The “**Challenge of Inclusion**” - “driver’s seat” vs “passenger” in the development enterprise.

World Bank’s *Comprehensive Development Framework*
Evolution of Developmental/ Aid Paradigms

2005 Paris Declaration on Aid Effectiveness:
(i) Ownership
(ii) Alignment
(iii) Harmonization
(iv) Managing for results; and
(v) Mutual Accountability and Partnership

The Millennium Challenge Account (MCA, 2004) of the US government

The 2006 UN Millennium Development Goals (MDG).

Inclusive Growth?
Aid Modality

A tool, an instrument, or form that transfers aid from donors to recipients.

Two basic forms:

- Project Aid
- GBS – General Budget Support
**Project Aid**

A form of aid to finance activities with a limited objective, budget, and time-frame to achieve specific results.

Earmark expenditures to specific activities to achieve coherent objectives with defined outputs and inputs.

**GBS**

Covers financial assistance as a contribution to host government’s overall national budget in support of general development strategy agreed between donor and host country government.

Do it all by donors or write a cheque and monitor the progress?

PBW and SBW

Donor dysfunction and recipient dysfunction
<table>
<thead>
<tr>
<th>Era / Priorities</th>
<th>Aid Modality</th>
</tr>
</thead>
</table>
| 1950s:          | • Project Aid (PA) and BOP support  
                  • Technical Assistance (TA) |
| • Capital Deficit  
• Knowledge and Technology Gaps | |
| 1970s:          | • More PA for rural development and investment  
                  • Ditto |
| • Income Distribution  
• Basic Needs | |
| 1980s:          | • Project Aid  
                  • BOP Support  
                  • SALs and Secals (Sectoral Adjustment Loans) |
| • Stabilization  
• Structural Reforms | |
| 1990s:          | • Project Aid  
                  • SALs and Secals  
                  • Program Aid linked to debt relief; HIPC Initiative; Sector Development |
| • Structural Reforms  
• External Debt | |
| 2000s:          | • Project Aid  
                  • Program Lending for Institutional Reform, Sector Development, Rule of Law  
                  • PRSC / IMF’s PRGF |
| • Institutional Deficit  
• Poverty Reduction | |
ADB Aid Modalities

PROJECT LOANS
A form of aid to finance specific activities with a limited objective, budget, and a timeframe to achieve specific results.

SECTOR LOANS
Assistance to a sector or subsector for project-related investments in a geographic area (area slice), over a period of time (time slice), or both.

- Enable an integrated focus on
  - sector development perspectives
  - sector policies
  - sector development plans and institutions

- Sector lending is appropriate when a number of subprojects are to be financed
ADB Aid Modalities

PROGRAM LOANS

Provide assistance in developing a sector and improving performance through **appropriate policy and institutional improvements**

- Finance is to cover the **immediate adjustment costs** arising from policy reforms
- Potential to have sector-wide and economy-wide impacts
SECTOR DEVELOPMENT PROGRAMS (SDP)

Combination of an investment (project or sector) and a policy-based program as well as attached technical assistance (TA)

- SDP fosters an integrated and generally long-term approach to sector needs
- Useful when a sector requires both investments and some policy reform, but where the investment component is unlikely to be accomplished without policy reforms
ADB Aid Modalities

EMERGENCY ASSISTANCE LOANS (EAL)

Short-term and small loans to help rebuild high priority physical assets and restore economic, social, and governance activities after emergencies.

EALs are designed to mitigate immediate losses to priority assets, capacity, or productivity rather than to provide relief or comprehensive reconstruction.
FINANCIAL INTERMEDIATION LOANS (FIL)

Provided to eligible financial intermediaries (FIs) for on-lending to subborrowers for eligible subprojects, at the FI’s own credit risk.

- Provided to FIs to finance specific development projects whose individual financing requirements are not large enough to warrant direct supervision by ADB
- FILs are provided in support of private sector-driven economic growth and poverty reduction
- Considered when there is effective demand for credit by potential sub-borrowers which cannot be met through existing sources
MULTITRANCHE FINANCING FACILITY (MFF)

Flexible framework for loans and guarantees, applied to an investment program coming out of a roadmap; spread over time in “slices” or tranches; combines physical and nonphysical investment activities

- Typically will include multiple subprojects, sequenced over the medium to long term,
- Provides a financing plan for a program of investments in an integrated package or series of related projects intended to achieve an overall development outcome
- Provides the ability to secure financing “as it is needed” against the agreed plan. Commitment fees only applied on committed amounts
ADB Aid Modalities

NON-SOVEREIGN PUBLIC SECTOR FINANCING FACILITY

Loans and guarantees for development projects on a direct basis to selected non-sovereign public sector entities without central government (sovereign) guarantees

- ADB assumes the credit risk of the borrower without additional support from the central government
- Financial terms are set on a commercial basis, similar to private sector loans
ADB Aid Modalities

REFINANCING FACILITY

Selective support to the restructuring of existing projects that may require additional capital or that could benefit from improved financing arrangements

- Designed to provide additional flexibility and facilitate ADB’s involvement in existing projects and programs

- Also allows expansion of projects with additional capital and the provision of management, technical, and policy advice
LOCAL CURRENCY LOANS

Loans structured in the local currency of a DMC

Offering loans denominated in a local currency may help borrowers mitigate the potential mismatch between borrowing in a foreign currency and having income streams to repay liabilities in its domestic currency.

PRIVATE SECTOR OPERATIONS

Risk Guarantees
Equity Investments
Direct Loans
Modality (terminology) Harmonization

GBS
- Direct BS, Multi-sector BS, SBS
- ADB?

SWAps
A mechanism for coordinating support to public expenditure programs with the objective of improving efficiency and effectiveness

Characteristics:
- Significant funding for a single policy/expenditure program
- Government leadership – country ownership
- Donor coordination, single source (TF)
- Gradual transition to GBS approach

ADB: Project Loans, Sector Loans, SDP, Program Loans, Program Cluster Approaches
Program-Based Approaches (PBAs)

Similar to SWAps, may include more than one sector

Programmatic Approaches

Fosters an integrated and generally long-term approach to sector investment and reform needs

ADB – MFF, Sector Loans, SDP

DPL

World Bank’s term for PBL

PRSC

WB’s programmatic approach tied to medium term PRSP, typically consists of 2–3 single-tranche operations
Aid Effectiveness

Aid Effectiveness - Effect of Aid on GDP growth

Aid Effectiveness - General

1980 – Inconclusive

1990 – No effect on growth, increase the size of the government

Aid is effective under “good macro economic environment”
Aid Effectiveness - Grant vs. Loans

Government Allocation Responses to Loans and Grants

<table>
<thead>
<tr>
<th>Aid Modality</th>
<th>Investment</th>
<th>Consumption</th>
<th>Tax Effort / Revenue</th>
<th>Borrowing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grants</td>
<td>(-)</td>
<td>(+)</td>
<td>(-)</td>
<td>0</td>
</tr>
<tr>
<td>Loans</td>
<td>(+)</td>
<td>0</td>
<td>(+)</td>
<td>(+)</td>
</tr>
</tbody>
</table>

Clements et al. (2004); Odedokun (2003, 2004); Djankov, Motalvo and Reynal-Querol (2004).

- Loan conditions of good macro promote growth; grants don’t (Swada et al. 2004)
- Degree of concessionality has no relationship to growth (Cordella and Ulku, 2004)
- Grants have a growth effect in poor, badly governed, highly indebted countries (Cordella and Ulku, 2004)
Project Vs Budget Support (Cordella & Del’Ariccia 2003)

- Unconditioned PA and BS has no Growth Effect
- BS conditioned on good macro positively related to growth
- PA conditioned on good macro has negative impact on growth

Tied vs. Untied Aid (Miguel-Florensa 2006)

- Tied aid has negative impact on growth
- Untied aid has a positive impact under good macro
## Relative Characteristics of Aid Modalities

<table>
<thead>
<tr>
<th></th>
<th>Project</th>
<th>Sector</th>
<th>SDP</th>
<th>Program</th>
<th>GBS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scale-Up Potential</td>
<td>Low</td>
<td></td>
<td></td>
<td></td>
<td>High</td>
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<tr>
<td>Donor Control</td>
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<td>Low</td>
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<td>Policy Change Prospects</td>
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<td>Implementation Failure Risk</td>
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<tr>
<td>Fiduciary Risk</td>
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<tr>
<td>Political Risk Vulnerability</td>
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<td>High</td>
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<tr>
<td>Cross-Cutting Benefits</td>
<td>Low</td>
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<tr>
<td>Donor Harmonization</td>
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<tr>
<td>Recipient Ownership</td>
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<td>Transaction Cost</td>
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<td>Corruption Vulnerability</td>
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<td></td>
<td>High</td>
</tr>
</tbody>
</table>

Transition from yellow to red represents rising intensity from low to high.
Aid Modality Choice

Agreement on general and sectoral policies and budget priorities?

- yes
- Assess macroeconomic stability, track record, commitment and institutional capacity, PFM system, governance, and rule of law
- good
- Can potential benefits be achieved (increased ownership, lower transaction costs, greater predictability, broader development impact)?
- yes
- Consider general budget support (GBS)

Agreement on specific sector policies and priorities?

- yes
- Assess sector capacity and financial management systems
- partial
- Can potential benefits (increased ownership, lower transaction costs, broader development impact) be achieved within the sector?
- yes
- Consider SBS

- partial
- Assess whether DMC has a sector development plan, comprising policy changes and institutional enhancement
- partial
- Assess commitment, ability and political will as well as previous experience to implement policy/institutional reforms
- good
- Consider program loan to achieve sector-wide and economy-wide impacts

- no
- Consider stand alone PA and TA if viable in weak policy environment

- unsure
- Consider SDP, Sector Loan, MFF, Project Loan

- none or deficient
- Consider SBS