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**Absorptive Capacity for
Foreign Aid**

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Foreword

The term "absorptive capacity" is used frequently in the economic and development literature and in discussions and negotiations between aid donors and recipients. However, its meaning is subject to different interpretations depending on the context within which it is used.

In this monograph, the author begins with an examination of the concept of absorptive capacity from the perspective of a foreign aid recipient government. He develops the concept of aid absorptive capacity gap which may act as a constraint on economic growth and then identifies and analyzes the determinants of the capacity to absorb foreign aid. The second part of the analysis focuses on the experiences of the Philippines and looks closely at the difficulties in programming foreign aid commitment. Building upon this, the author provides an assessment of the near term foreign aid requirements and contrasts this with the Philippines' absorptive capacity.

Using four aid sources as specific cases, reasons for delay and difficulties in aid programming are identified at various points in the process. This analysis leads to recommendations to improve the translation of aid commitments into effective programs. The analysis, while specific to the Philippines, should be of broader interest on two accounts. First, the analysis of the factors determining absorptive capacity raises issues and identifies problems which in varying degrees plague all aid recipients. Second, the considerations related to the calculation of the aid requirements and the capacity to absorb aid can be guides to similar efforts elsewhere.

The author, Romeo Reyes, is Director-General of the Philippine National Economic and Development Authority. This work was completed during the year he spent in residence at the Metropolitan Studies Program as a visiting scholar.

David Greytak
Syracuse, New York
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Absorptive Capacity for Foreign Aid

Romeo A. Reyes¹

Introduction

The term "absorptive capacity" is used frequently in the economic and development literature and in discussions and negotiations between aid donors and recipients. However, its meaning is subject to different interpretations depending on the context within which it is used. Previous studies have been made to clarify the concept and to identify factors determining its limit.² To facilitate understanding of a situation where aid is supposedly available to a recipient country and yet it is not availed of or absorbed, further clarification of the concept, specifically with reference to foreign aid, is deemed necessary.

Purpose of Study

This paper is in two parts. The purpose of the first part is: (a) to inquire further into the meaning of "absorptive capacity" when used in the broad context of capital and, more particularly, in the narrower context of foreign capital and *foreign aid*; and (b) to identify and analyze its determinants from an aid-recipient country perspective. The second part attempts to make an assessment of the capacity of a specific recipient country—the Philippines—to absorb foreign aid

1. Assistant Director-General, National Economic and Development Authority (NEDA), Republic of the Philippines, *on leave* as Visiting Scholar, Maxwell School of Citizenship and Public Affairs, Syracuse University. The views expressed herein are solely mine and do not necessarily reflect those of the NEDA nor the Maxwell School. Financial support from the Philippine Institute for Development Studies (PIDS) and the United Nations Development Programme (UNDP) is gratefully acknowledged.

2. See, for example, John H. Adler, *Absorptive Capacity: The Concept and its Determinants* (Washington, DC: The Brookings Institution, June 1965).

particularly those forthcoming for the remainder of its current plan period (1989-1992) and suggests measures which might enhance its absorptive capacity.

Relevance and Timeliness of Study

After the change of government in February 1986 following years of economic contraction and political uncertainty, the Philippines embarked on a program of economic recovery in the short run and sustained economic growth in the longer run. Strong international support to the program was manifested, among others, in terms of additional pledges of aid from traditional sources and substantial initial pledges from new sources. Since 1986, the two biggest traditional sources of bilateral aid, namely Japan and the United States, have committed annual levels of assistance which are significantly higher than those committed before the change in government even as new sources of bilateral aid, e.g., Italy, Netherlands, emerged with pledges of similarly significant amount of aid. By early 1987, however, the same bilateral and multilateral sources of aid which declared strong support to the new government began expressing concerns either directly to the government or through the local and international media over delays in disbursement of aid (both concessional loans and grants) already committed for specific projects/uses and in committing or obligating those which have been pledged as available and programmable. The Philippine Congress also manifested its concern when it summoned responsible officials of the Executive Branch to testify and shed light on the matter.

The initial response of the Philippine government was to take a number of measures mainly geared towards expediting preparation and implementation of foreign-assisted projects inasmuch as the bulk of aid to the Philippines comes in the form of project assistance. While these measures have somewhat improved the rate of project preparation, appraisal/processing, and implementation, many officials from aid sources and even from the Philippine government (including

the Legislative Branch) continue to be concerned over the capacity of the country to absorb greater amounts of aid in the medium term (1989-1992), particularly in the event that a significant aid initiative for the Philippines becomes a reality. This initiative, originally referred to as a "Mini-Marshall Plan," was proposed by a group of legislators from the U.S. Congress to the Executive Branch. It was later renamed by the Philippine government as the Philippine Aid Plan (PAP) and by the international aid community as Multilateral Aid Initiative (MAI) for the Philippines.

The PAP or MAI envisions mobilization of an additional \$5 to \$10 billion of foreign assistance within the next four to five years from both bilateral and multilateral sources. Towards this end, a pledging conference chaired by the World Bank was held in Tokyo on July 4-6, 1989, involving 19 countries and 7 international financial institutions. At the conclusion of the Paris Summit of the Group of Seven on July 16, 1989, it was declared in the communique that they

"note with satisfaction that there has been substantial progress in the multilateral aid initiative for the Philippines that was given special attention in the Toronto economic declaration."³

On the part of the Philippine government, a new Coordinating Council on the Philippine Assistance Program (CC-PAP) was created in January 1989 chaired by a full-time official with cabinet rank to oversee the mobilization, programming and use of aid expected to be forthcoming under the PAP. Subsequently, a Committee on Official Development Assistance (CODA) within the National Economic and Development Authority, the country's planning agency, was created on June 23, 1989, and specifically

"authorized to undertake the various aspects of the official development assistance (ODA) including programming, coordination of program and project development and of negotiation for foreign assistance, and

3. *New York Times*, July 17, 1989, p. A7.

monitoring of and where necessary, supervision of the project implementation, all in accordance with the policies set by the National Economic and Development Authority Board."⁴

The Chairman of the Coordinating Council on the PAP was also designated as Chairman of CODA.

Scope of Study

Chapter I defines foreign aid for the purpose of this study and briefly presents the fundamental economic justification for foreign aid from a recipient country standpoint. The underlying principles and assumptions behind the two-gap theory justifying aid as an additional resource which developing countries need to attain self-sustained economic growth and the evidence thus far are then reviewed briefly in this chapter.

Chapter II seeks further clarification of the term "absorptive capacity" particularly in the context of foreign aid and introduces the concept of an aid absorptive capacity gap constraining economic growth. Chapter III then identifies and analyzes what might be considered as factors influencing the capacity of recipient countries to absorb aid. In this regard, a distinction is made between foreign aid available only for investment financing and that made available for many other purposes in addition or as an alternative to investment financing. It looks at attitudes, policies and decision-making processes of both recipient and donor countries with respect to foreign aid. On the part of donors, the policy of multiple tying of aid and the motivation for imposing this restriction in aid use is given more attention in view of its relatively stronger impact on the ability of recipients to absorb aid expeditiously and to use aid effectively in closing the external financing gap.

Part II of the study focusing on the Philippines as a specific recipient country begins in Chapter IV where its economic performance in terms of income growth,

4. Republic of the Philippines, Administrative Order No. 128, p. 1.

capital absorption and investment efficiency since the second half of the 1970s was reviewed to provide the context in which foreign aid was programmed and used. More particularly, it reviews the share of foreign savings in financing domestic investment, how the corresponding current account deficit in the Balance of Payments was financed, and the role of aid, including concessional loans, in the evolution and financing of the current account deficit. The accumulation of external debt and the increasing burden of servicing it are necessarily given due attention. Historical origin of foreign aid up to 1988 in terms of commitment was also traced. The last part of the chapter is devoted to analysis of recent performance of the Philippines from 1986 to 1988 in foreign aid absorption in terms of its ability to translate aid pledges into commitments and further into actual disbursements.

The first part of Chapter V looks closely into the process of translating aid pledges into commitments. Using four aid sources as specific cases, reasons for delay and sources of difficulties in aid programming are identified at various points in the process and certain measures are recommended to forestall their recurrence in the future. The second part, on the other hand, looks at the process of translating commitments into disbursements for the same purpose. Steps taken so far to expedite the process of translating aid pledges into commitments and actual inflows are then analyzed in Chapter VI.

Finally, an assessment of how much aid is required for the remainder of the current plan period (1989-1992), how much is likely to be available and committed and how much might be considered "manageable" taking into account absorptive capacity limits is made in Chapter VII.

Chapter I

Foreign Aid and Economic Growth

Definition of Foreign Aid

In the literature, foreign aid is sometimes treated as synonymous to capital inflow to less developed countries (LDCs) and measured indirectly in terms of amount required to finance the current account deficit of an LDC. One author, however, rightly pointed out that

"aid, properly speaking, refers only to those parts of capital inflow which normal market incentives do not provide".⁵

Since capital inflows in the form of commercial loans and foreign investments are responses to normal market incentives, they are excluded from the definition of foreign aid. Other private flows like those coming from private foundations and other nongovernmental organizations are also normally excluded from the definition. The term is now used to mean

"flow of long-term official financial resources between developed and developing countries."⁶

The flow may be directly from the government of one country to another or indirectly through multilateral agencies like the UN System or international/regional financial institutions like World Bank or Asian Development Bank. Aid may be provided in grants or in loans, i.e., with repayment obligation. While grants are considered as aid at their full face value, only the "grant element" of the face value of a loan may be considered as aid. When aid is provided in the form of loans, the net inflow of financial resources to the recipient country is reduced by the outflow due to debt service and may eventually be reversed in the future.

5. P.N. Rosenstein-Rodan, "International Aid for Underdeveloped Countries", *The Review of Economics and Statistics* XLIII,2 (May 1961):109.

6. J.M. Healey, *The Economics of Aid* (Beverly Hills: Sage Publications, 1971), p. 2.

When aid is primarily intended to promote economic and social development of recipient countries and provided in concessional terms, it is referred to as development aid or development assistance. When it originates from official sources, i.e., government agencies and instrumentalities, it is referred to as *official development assistance* (ODA) and defined by the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) as

"those flows to developing countries and multilateral institutions provided by official agencies, including state and local governments, or by their executive agencies, each transaction of which meets the following tests: (a) it is administered with the promotion of the economic development and welfare of developing countries as its main objective; and (b) it is concessional in character and contains a grant element of at least 25 percent."⁷

The grant element of a loan which in a sense corresponds to the aid component of the loan is computed as the difference between the face value of the loan and the discounted present value (at 10 percent discount rate) of the debt service payments (interest and principal). It is often expressed as a percentage of the face value. For purposes of this paper, foreign aid is defined in accordance with the DAC's definition of ODA. Foreign aid and ODA will therefore be treated synonymously and used interchangeably. All grants and concessional loans meeting or approximating the DAC's grant element criteria flowing from governments of developed countries and from international agencies and multilateral financial institutions, i.e., U.N. agencies and international and regional development banks, to recipient countries will be considered as foreign aid or ODA.

7. OECD, *Development Cooperation* (Paris: 1978), p. 171.

Economic Justification for Foreign Aid: The Theory and Evidence So Far

The economic justification for foreign aid derives from the inability of developing countries during early stages of development to generate enough domestic savings to finance domestic investment and enough exports to finance imports required in pursuing their development objectives. There is therefore either a resource gap or a foreign exchange gap.⁸ Although the two gaps are equal in an *ex-post* or accounting sense, they need not be equal in an *ex-ante* sense as people who invest and import need not be the same as those who save and export. To achieve development targets, the gap will have to be filled by foreign savings through either private or official flows. Private flows in the form of commercial loans or foreign investment are often inadequate. Foreign equity may not come in because of perceived or real investment risks. Commercial loans, on the other hand, may not be available because of perceived or real credit risks. If available, it may not be availed of because of their relatively hard terms. Official flows particularly in the form of foreign aid would therefore be necessary to fully close the resource/foreign exchange gap so that development targets may be achieved.

The basic underlying assumption is that the existence of the resource gap or the foreign exchange gap and the need for aid to fill it up will be temporary. With additional resources that aid made available, the constraint to growth would be removed. As the economy grows over time and its ability to save and to earn foreign exchange is correspondingly enhanced, it will eventually be able to finance its own investments and imports. Self-sustained growth would therefore be possible eventually after a period of aid-sustained growth. But foreign aid would be required initially to reach the period of self-sustained growth.

8. For a detailed explanation of this justification for aid, see Hollis B. Chenery and Alan M. Strout, "Foreign Assistance and Economic Development," *The American Economic Review* LVI,4 (September 1966).

By not mentioning debt service requirements in the future, we have assumed in the foregoing that aid is provided entirely in the form of grants. However, as pointed out earlier, aid also comes in the form of concessional loans.

Provision of aid in the form of concessional loans which carry repayment obligation in the future but with relatively lower rate of interest is also premised on the aforementioned assumption but goes one step further. The further assumption is that increased ability in the future to save and to earn foreign exchange will be enough not only to finance its own investment and imports but also to generate a surplus for debt servicing. The case of commercial loans is similar to concessional or official loans but the expectation with respect to generating a surplus in the future is more optimistic in the case of the former. When commercial loans from the banks flowed massively in the 1970s to now-heavily-indebted countries, both the banks and the debtor countries presumably had the same underlying assumptions in mind and hoping that those assumptions were realistic.

As outstanding loans (both concessional and commercial) increase, debt service burden would also increase so that, at some point in the future, foreign exchange outflows due to debt service will eventually exceed inflows from new loans thereby reversing resource flows. The expectation or the hope is that by then the economy will have a higher level of GNP and greater capacity to save and to earn foreign exchange enough to generate a surplus, i.e., the level of savings and exports is high enough to cover investments and imports, respectively, and to service maturing debt obligations. While outstanding debt and debt service in absolute amount would be sizable, they would be declining as a proportion of GNP and exports. Therefore, the debtor country will acquire the capacity to repay and will not default provided that it is given enough time to

undergo the process of transition from a growth path which is aid-sustained or debt-sustained to one which is self-sustained.⁹

For aid to effectively help a recipient country in making the transition from a growth path which is aid-sustained to one which is self-sustained, there are other underlying assumptions and expectations. As additional resources in the form of aid are made available, it is also assumed that they will in fact be used for investments or for imports of investment goods or, if not used directly for that purpose, to liberate domestic resources for the same purpose. Furthermore, as additional income is generated through productive investments made possible by aid, it is also expected that a good portion of this income will be saved and similarly used for economically productive purposes so as to reduce the resource gap or the foreign exchange gap in the long-term. Aid may therefore be viewed as a growth catalyst or stimulus and, as such, the efficiency with which successive additions to income as a result of aid is used would be more critical than the efficiency with which aid itself is used in the first instance.¹⁰ More attention should therefore be given to promoting efficiency in the use of *total* resources, including aid, in the long-term during the period of transition rather than attempting to ensure that aid itself is used efficiently in the first instance through the mechanism of project assistance. Many donors/creditors resort to this mechanism in the belief that tying aid to specific projects (and in most cases to their foreign exchange cost or imported goods/services) is an effective way of promoting short-term efficiency in aid use. However, because of restrictions

9. For an excellent explanation and graphical illustration as to how a country undergoes the process of transition from a stage of increasing debt/GDP ratio to one which is diminishing, see Marcelo Selowsky and Herman G. Van Der Tak, "The Debt Problem and Growth," *World Development* 14,9 (1986):1107-1124.

10. Chenery and Strout, "Foreign Assistance and Economic Development, p. 74.

associated with aid-tying, it would tend to distort the pattern of the total investment program thereby reducing efficiency of total resource use.¹¹

The empirical evidence that aid help recipient countries in attaining or moving towards self-sustained growth by reducing the resource gap or the foreign exchange gap is mixed. In the early 1950s and late 1960s, Chenery and Strout cited Greece, Israel, Taiwan and even the Philippines as cases where

"a substantial increase in investment financed largely by foreign loans and grants has led to rapid growth of GNP followed by a steady decline in the dependence on external financing. Not only was growth accelerated by foreign assistance, but the ability of each economy to sustain further development from its own resources was very substantially increased."¹²

The expectation that foreign capital inflow made possible by aid will be used for investment to stimulate growth is refuted, however, by many authors.¹³ They presented evidence that foreign capital inflow (F), instead of being used entirely for investment, were used in part for consumption. Summarizing the findings of these authors, Papanek reported that

"all of the critical analysis agree that the average impact (of a dollar of F) has been to increase investment by only \$0.11 to \$0.77."¹⁴

Based on this evidence, it may be argued that, instead of supplementing and stimulating domestic savings, aid was used to supplant or as a substitute for domestic savings. Since investment (I) is financed either by domestic savings (S) or foreign capital inflow (F),

$$S + F = I,$$

11. This is explained in greater detail in Chapter III.

12. Chenery and Strout, "Foreign Assistance and Economic Development, p. 679.

13. See, for instance, K. B. Griffin and J. L. Enos, "Foreign Assistance: Objective and Consequences," *Economic Development and Cultural Change* (April 1970); Thomas Weisskoff, "The Impact of Foreign Capital Inflow on Domestic Savings in Underdeveloped Countries," *Journal of International Economics* (February 1972); and Kaj Areskou, *External Borrowing: Its Role in Economic Development* (Praeger, 1969).

14. Gustav Papanek, "The Effect of Aid and Other Resource Transfers on Savings and Growth in Less Developed Countries," *Economic Journal* (1972:908).

and $S = I - F$

A dollar increase in F , therefore, which does not increase I by a full dollar will necessarily decrease S and increase consumption. Papanek argued, however, that this is true only in an accounting sense and would be appropriate only if F is either used for I or represents a claim in past or future S . Otherwise, it would be misleading. He then cited foreign aid in the form of grants which is deliberately provided to increase consumption rather than investment, e.g., food aid or grant for delivery of family planning services. Since it is a grant, it does not affect current savings nor did it use past savings nor will it have any claim on future savings, yet F increased to allow higher private or government consumption. We shall return to this point later when we discuss in more detail that, in reality, foreign aid is used for many purposes other than investment financing and therefore $S + F \neq I$.

Papanek pointed out further that the evidence regarding the relationship between high capital inflows and low savings and, in some cases, low growth rates did not establish causality and that other factors may have influenced the behavior of savings. Furthermore, aid is just a component of foreign capital inflow and its impact on growth may have been lost when it is lumped or amalgamated with private foreign investment and other inflows. He then went on to do his own investigation based on the hypothesis that domestic savings, aid, private foreign investment and other inflows are determinants of growth. He found that savings and all foreign inflows explain over one third of growth and that, among the determinants, aid has a more significant effect on growth.¹⁵ Compared to savings, aid is a more powerful determinant because, as the two gap theory points out, aid closes not only the resource gap but also the trade gap.

15. Gustav Papanek, "Aid, Foreign Private Investment, Savings and Growth in Less Developed Countries," *Journal of Political Economy* 81,1 (January-February 1973):120-130.

However, even after isolating aid from total foreign inflows, aid and domestic savings were found to be negatively correlated. While this confirms the findings of previous authors when aid was amalgamated with other foreign inflows, Papanek maintained that correlation between the two variables need not mean causality.

A more recent empirical work on the impact of aid on growth made use of more recent data, (1960-1970), (1970-1980), (1980-1983) and added two more variables as possible determinants, namely, growth of exports and growth of literacy. The conclusion

"is that aid in the aggregate has no demonstrable effect on economic growth in recipient countries in either period."¹⁶

This is contrary to the positive findings of Papanek in the 1960s. In fact, the multiple regression coefficient of aid on growth is negative (-0.0492) and significant at the 5 percent level in the 1960s, positive but altogether insignificant in the 1970s and positive and insignificant again in 1980s.¹⁷

While all of these evidences on the relationship between aid and growth are merely suggestive, they are nonetheless contradictory thereby leaving the fundamental theoretical justification for aid an outstanding empirical question. Sounding somewhat frustrated in his search for a development economics and definitely less optimistic now than when he wrote a textbook on the subject, Henry Bruton remarked that

"aid is necessary in a variety of ways, but one of the great failures in development economics has been its inability to see clearly where aid can help and where it harms and defeats."¹⁸

16. *Ibid.*, p. 631.

17. Paul Mosley, John Hudson and Sara Harrel, "Aid, The Public Sector and the Market in Less Developed Countries," *Economic Journal* (September 1987):631.

18. Henry J. Bruton, "The Search for A Development Economics," *World Development*, 13,10/11 (1985):1120.

Chapter II

The Concept of Absorptive Capacity

In general, absorptive capacity refers to the ability of an economy to use capital productively regardless of its source (whether local or foreign) based on some standard of productivity. In many instances, the term is used with reference to foreign capital only. When used in the context of foreign aid, some refer to it as the capacity to use assistance as a source of financing for economically viable investment projects only (capital assistance) while others take it to mean as inclusive of technical assistance. As there are many alternative uses of aid other than capital/technical assistance depending on the restrictions which a particular donor may impose, the term could mean simply as the capacity of a recipient country to program and use foreign assistance in a manner which is acceptable to donors, be it for capital or technical assistance projects, financing of current imports, financing of budget deficit, debt relief, etc. Perhaps because the term connotes different meaning, it is often referred to in the literature in quotation. Consider, for example, the following observations which allude to administrative complexities on both recipient and donor of aid as factors limiting absorptive capacity for foreign aid.

"It is generally recognized that the transfer of a given amount of development assistance takes a long time.... This happens because of administrative complexities on both sides.... All these factors make up what is generally referred to as 'absorptive capacity' of the borrower country, although it is clear that the modus operandi of the donor institution itself contributes to the limitations on resource absorption."¹⁹

Consider another observation from an author who identifies skilled manpower as one of the factors limiting an economy's absorptive capacity.

"In practice, however, growth depends heavily on the availability of skilled workers, managers, technical personnel and civil servants. The

19. Judith Tendler, *Inside Foreign Aid* (Baltimore: John Hopkins University Press, 1975), p. 86.

lack of these skills can severely limit the amount of productive investment which can be planned, organized and executed and sets what is commonly called the 'absorptive capacity' of an economy."²⁰

The concept of absorptive capacity with respect to capital (regardless of source) derives from the principle that the productivity of investment or marginal efficiency of capital declines as the rate of investment increases. According to this principle, there is a limit to the amount of capital which can be used productively in an economy. Absorptive capacity may then be defined as that amount of investment, or that rate of gross domestic investment expressed as a proportion of GNP, that can be made at an acceptable rate of return.²¹

In addition to measuring or expressing absorptive capacity in absolute amount or as a ratio of GNP, it may also be expressed in terms of observed rate of growth of investment for a specific time period. For example, in Chenery and Strout's two-gap model, the concept of absorptive capacity limit was used as a parameter. It was "indicated by the compound growth of investment for any five-year period in the past decade."²²

The amount of investment consistent with the absorptive capacity of an economy is to be distinguished and need not be equal to the amount of investment (regardless of the rate of return) required to achieve a reasonable output target for which domestic savings or foreign savings may be available.

If the latter is greater than the former, one could imagine an absorptive capacity gap constraining growth rather than a resource gap. In the two-gap model, this corresponds to Phase I which ends

20. Healey, *The Economics of Aid*, p. 46.

21. Adler, *Absorptive Capacity: The Concept and its Determinants*, p. 5.

22. Chenery and Strout, "Foreign Assistance and Economic Development," p. 705.

"when investment reaches a level adequate to sustain the target rate of growth."²³

Under this phase, there is a limit on the ability to invest or on absorptive capacity for additional investment due to limitation in the supply of inputs complementary to investment which can only be increased as a result of the development process.²⁴ In Chenery and Strout's formulation, the limit on the supply of complementary inputs which, in turn, limits the ability to invest is referred to as

"skill limit—reflecting the skill formation required of managers, skilled labor, and civil servants in order to increase productive investment."²⁵

As the incentive to save may be affected by the ability to invest, Rosenstein-Rodan suggested use of observed savings effort indicated by maintenance of or widening of deviation between marginal and average rates of savings as an index for estimating absorptive capacity.²⁶ He also endorsed the proposal of M.F. Millikan and W.W. Rostow to use judgment on a country's overall administrative and developmental organization as an alternative measurement index.²⁷

The concept of absorptive capacity may be further clarified if viewed in terms of "a schedule relating an amount of capital to be invested to the expected rate of return."²⁸ Using current terminology in investment appraisal, the schedule may be referred to as an Expected Economic Internal Rate of Return (EIRR) function which relates the level of investment to the expected EIRR. Following

23. Chenery and Strout, "Foreign Assistance and Economic Development," p. 687.

24. In the foregoing definition of absorptive capacity by John Adler, the supply of complementary inputs which he calls "cocoperant factors" is considered as given.

25. Chenery and Strout, "Foreign Assistance and Economic Development," p. 687.

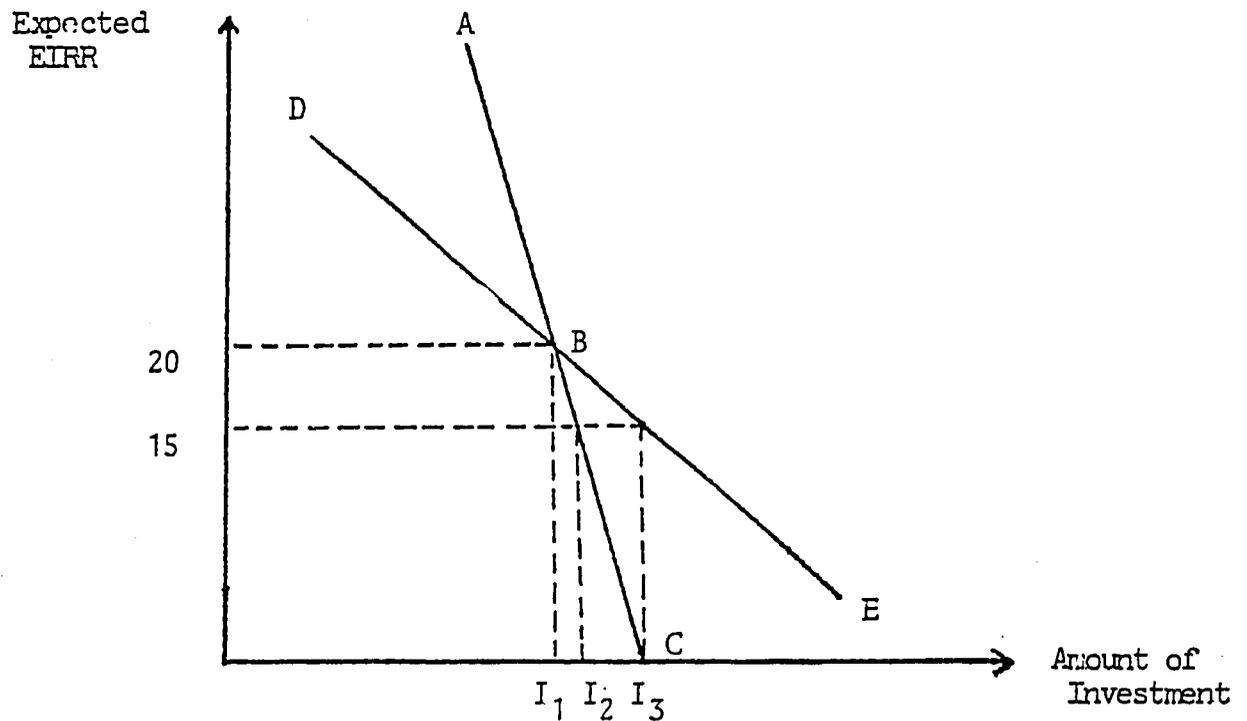
26. Rosenstein-Rodan, "International Aid for Underdeveloped Countries," p. 108.

27. M.F. Millikan and W.W. Rostow, *A Proposal: Key to An Effective Foreign Policy*, Harper and Brothers, New York, 1957, Chapter V and VI.

28. Adler, *Absorptive Capacity: The Concept and its Determinants*, p. 2.

the principle of diminishing marginal efficiency of capital, the expected EIRR declines as the level of investment increases.

FIGURE I



In Figure I above, the EIRR function of a less developed country may be depicted by line ABC while that of a developed country by line DBE. At investment level I_1 , the expected EIRR in both countries is 20 percent. If the economic opportunity cost of capital in both countries is 15 percent and the policy is that any investment whose EIRR is lower than the opportunity cost of capital is not acceptable, the limit to absorptive capacity of the less developed country is reached sooner at I_2 compared to I_3 in the developed country. I_2 therefore becomes the maximum amount of capital which can be used to generate an acceptable rate of return of 15 percent in the less developed country which is smaller than I_3 in the developed country.

The slope of the EIRR function in the less developed country is more steep and, therefore, expected EIRR declines more sharply as investment increases due to more limited investment opportunities whose return is acceptable. At I_3 , expected EIRR in the developed country is still acceptable while that of the less developed country already approaches zero. In order to raise the limit of its absorptive capacity, the LDC would have to generate and identify investment opportunities whose rate of return would be acceptable at 15 percent. Graphically, this would be a movement from line ABC to DBE.

So far, clarification of the meaning of absorptive capacity has been attempted with respect to capital regardless of its source. However, the same approach and method of analysis can be applied to foreign capital only and, to a more limited extent, to foreign aid or official development assistance (ODA) in the form of concessional loans and grants with some modifications owing to the nature of foreign capital and ODA in particular as a source of development financing.

If capital is sourced from abroad and its use in the capital importing country is not restricted, its availability may have the effect of increasing productive investment opportunities or rate of return on capital in the capital importing country and, therefore, absorptive capacity. The reason is that availability of foreign exchange occasioned by inflow of foreign capital would allow access of the capital importing country to "cooperant factors" or inputs complementary to capital which are not or insufficiently available locally, e.g., technology, skills, critical production inputs, etc. Going back to Figure I, this would have the effect of making the slope of the EIRR function in the less developed country less steep so that line ABC would tend to move towards DBE.

When the concept of absorptive capacity as explained above is applied to foreign aid, its application must necessarily be confined to foreign aid made available only for capital assistance, i.e., for financing investment which generate

acceptable returns. Absorption of foreign aid which may be used for other purposes, e.g., technical assistance, disaster or debt relief, food aid, financing of current imports or of government current expenditures, would obviously be a function of other factors not necessarily related to availability of productive investment opportunities. We shall return to this point later when determinants of absorptive capacity are dealt with.

The amount of foreign aid consistent with the absorptive capacity of the economy, i.e., amount which can be used to finance investment with acceptable rate of return is to be distinguished and not to be confused with foreign aid required to close a resource gap so that economic growth targets may be achieved. Even if foreign aid is available to supplement domestic savings, it may not be availed of or absorbed because of limited investment opportunities which would generate acceptable returns. There is therefore an absorptive capacity gap with respect to foreign aid rather than a resource gap limiting economic growth. The difficulty is not in the ability to generate foreign financing but to generate, recognize and demonstrate investment opportunities for which foreign financing would be available. If the country's ability to invest productively is due to limited availability of "skilled workers, managers, technical personnel and civil servants,"²⁹ for project identification, preparation and evaluation, part of aid itself may be used not necessarily for investment financing but for "discovering" investment opportunities and demonstrating their acceptability in terms of rate of return. Aid therefore may be used to reduce or close the absorptive capacity gap beforehand to subsequently allow closing of the investment-savings gap. The existence of an absorptive capacity gap is best exemplified when donor representatives come around and complain that they are authorized to commit a

29. Healey, *The Economics of Aid*, p. 46.

certain level of assistance but could not because there is a dearth of "good" projects. Indeed, the absorptive capacity gap may effectively be the constraint to growth rather than the resource gap or foreign exchange gap when field personnel of donor agencies report that

"there are many cases where the shortage of good projects is even more serious than the shortage of capital or foreign exchange."³⁰

In many instances, productive investment opportunities documented and demonstrated in the form of "good" projects may, in fact, not exist due to economic factors such as market limitation. In other instances, however, such opportunities do exist but may not be known to, or recognized by, appropriate parties simply because no systematic efforts have been made to "discover" or identify them and to demonstrate that they do exist. If part of aid is used for discovering and demonstrating investment opportunities, aid in itself, can enhance a country's absorptive capacity.

30. UNDP, *An Evaluation of UNDP Assistance to Uganda*, 1969, as quoted in Dennis Rondinelli, *Development Projects as Policy Experiments* (New York: Meethuen & Co., 1983).

Chapter III

Determinants of Absorptive Capacity for Foreign Aid

In analyzing the determinants of a recipient country's absorptive capacity for foreign aid, it would be necessary to make a distinction between: (a) aid whose utilization is *restricted* to financing of investments—either for a specific project, for a set of projects constituting a sector investment program or for the entire investment program of the country, if any, including the private sector; and (b) aid which may be used for investment financing and/or for other purposes such as technical assistance for pre-investment activities, research and development (R&D), project management and general institution building, financing of current imports including food (balance of payments support), financing of government current expenditures (budget support), and debt relief. Category (a) is often referred to as capital assistance and is typically provided in the form of concessional loans for specific projects. Aid under category (b) is typically provided in grants particularly in the case of technical assistance.

Aid Restricted to Financing of Investments

The absorptive capacity of a recipient country with respect to capital assistance or aid restricted to investment financing is necessarily related to the supply of investment projects whose rate of return is mutually acceptable to donor and recipient. The minimum rate of return which the donor and recipient country deem acceptable would therefore be a determinant of absorptive capacity with respect to this type of foreign aid. The lower the acceptable rate of return, the higher would be the absorptive capacity. In many countries, the rate of return on investment is measured in terms of EIRR, i.e., the rate of discount which equates discounted flow of benefits and of costs. The minimum EIRR considered

acceptable is that rate which is equivalent to the shadow price of capital reflecting its true scarcity value. This in turn is measured in terms of its opportunity cost—or the return of an additional capital if put to its best alternative use.³¹

There are three considerations in this regard which are relevant to an analysis of a country's absorptive capacity: the availability of an estimate of the opportunity cost of capital; its reliability; and the policy with respect to the use of a quantitative measure of the return on investment (e.g., EIRR) for deciding whether a proposed project should be implemented/funded.

Estimation of the opportunity cost of capital (OCC) like other project planning parameters (shadow price of labor, foreign exchange, etc.) which are needed in measuring economic rates of return involves rigorous methods and requires timely and reliable data as well as skills whose supply in LDCs is rather scarce. Often, estimates of the OCC in developing countries would not be too timely and reliable, if they exist at all. If there is no estimate of the economic opportunity cost of capital, determination of what would be an acceptable return would have to be based on some other criteria like the market rate of interest which may be very different from the OCC in developing countries or on some subjective judgment by policy makers. It is also possible that what may be considered as an acceptable return in one sector say, health, may not be so in another, say energy. In this case, absorptive capacity would depend on the subjective judgment of policy makers with respect to what may be considered as

31. Other conventional measures of investment project profitability are Net Present Value (NPV) and Benefit-Cost Ratio (B/C). Calculation of these measures requires specification of a social rate of discount or the rate at which future benefits and costs will be discounted to the present. Depending on the numeraire used in project evaluation, the social time preference (STP) rate reflecting society's valuation of future consumption vis-a-vis present consumption or the OCC may be used as the discount rate. If the numeraire is consumption, STP is used; if it is investment, OCC is used; if it is income, either one may be used. Under a go-no-go decision-making situation, the decision rule is go if: (1) EIRR is greater than OCC; and (2) NPV is positive or B/C is greater than one at the prescribed discount rate.

an acceptable return on investment in the economy or in a particular sector and the extent to which such judgment find acceptance to donors. Where estimates are available, they may not be considered reliable by decision makers from both recipient and donor countries either because the validity of the method used is doubtful or the data used are already outdated. Similar subjective judgment on what would be an acceptable return would therefore have to be resorted to.

But even when estimates of OCC are up-to-date and considered reliable, there is a limit to its usefulness as basis for a go-no-go decision taking. Availability of a reliable and updated measure of the OCC against which returns on investment for various projects can be judged in terms of acceptability would be useful only to the extent that return on investment from an economic and social standpoint would lend itself to quantitative measurement. Unlike benefits from large projects in infrastructure and agriculture which are susceptible to identification and quantification, those from the social sector are not, in most cases. For example, it would be difficult if not altogether impossible to translate into a quantitative measure such as EIRR, NPV or B/C ratio, the return on investment in human capital such as in education or health. Even when other quantitative analytical tools, e.g., cost-effectiveness analysis,³² as an alternative to benefit-cost analysis are applied to socially-oriented projects, the result is not a measure of the rate of return per unit of investment cost. Rather, it is a measure cost per unit of effect, e.g., \$500 per life saved in the case of a health project, which is not comparable to the cut-off rate of return based on the OCC. Some subjective judgment will again be necessary to determine the acceptability of investment. As in previously cited cases, said judgment would affect absorptive

32. For a simple and straightforward explanation and application of cost-effectiveness analysis, see Republic of the Philippines, National Economic and Development Authority, *Project Development Manual* (Manila, September 1984), p. 212.

capacity positively or negatively for foreign-funded projects in health and education depending on what the recipient and donor mutually consider as an acceptable cost-effective intervention as opposed to an acceptable rate of return.

The policy of a recipient country as to whether all proposed investment projects, regardless of financing source and terms, would be treated the same way without exception in investment decision-making would also affect its capacity to absorb foreign capital in the form of aid.

Foreign aid for investment financing is typically tied to a project's implementation. Alternative uses (if any) are usually confined to a limited set of projects which the donor is interested in. If the donor is interested in only one project (which is an extreme case), capital made available for that project in the form of a grant (no interest nor repayment obligation) would have no opportunity cost, i.e., the opportunity cost of that capital or aid is zero. If the entire project cost is funded solely by the grant, it makes economic sense for the recipient country to avail itself of the grant and to implement the project as long as an economic benefit is generated, regardless of the estimated OCC in the recipient country or the social discount rate used in project evaluation. The reason is that this amount of capital which has no alternative use and no financial nor economic cost would have a positive NPV at a discount rate approaching zero or at a higher discount rate, say, 15 percent. If there are other costs not covered by the grant, the project should also be implemented as long as the Net Present Value (NPV) is positive, using the OCC as the social discount rate, or as long as EIRR is equal to or greater than the OCC. The calculation, however, of the profitability indicators should take explicit account of the fact that capital provided as a grant to the project does not have any alternative use as it is tied to that single project and will not involve any use of real resources for debt service.

If aid were in the form of a loan carrying a 2 percent rate of interest payable in 20 years with five-year grace, then the calculation should be so adjusted as to take account of the financing terms, particularly the timing and amount of debt service. It is only when resources are used for debt service of this tied loan that an economic or opportunity cost to the economy is incurred.

If there is more than one project whose NPV is greater than zero or EIRR is greater than OCC that the donor is interested in (which is the usual case) and aid is available as a loan as before, the project yielding the highest NPV or EIRR should then be implemented and the loan availed of. If other projects could be accommodated by the loan, those with the next highest returns in succession should be chosen.

Since tied aid can be used only for a limited set of projects which a donor is interested in, it is not available for other alternative uses in the economy of the recipient. If aid is a loan, it is the resources for debt servicing in the future that are available for alternative uses, including its best alternative use. Therefore, it is only when debt service payments are made (rather than when loan proceeds are used) that an economic or opportunity cost to the recipient's economy is incurred. If aid is a grant, it follows that there is no cost to the recipient.

Operationally, this means that investment cost should not be reckoned completely in year zero when the expenditure is incurred. Instead, expenditures financed by the tied loan should be reckoned in future years when payments for debt service are made and those financed by outright grants should not be reckoned at all. This is to take explicit account of the fact that, unlike domestic capital, tied foreign capital has different costs.

If aid is tied not only to the project but also to procurement (which is common among bilateral sources), the additional cost of sourcing the procurement from the donor country at a price likely higher than if it were

through international competitive bidding should also be fully accounted for. The lower financing cost of tied aid can be more or less than offset by the higher price at which project inputs are procured.

Thus, investment projects proposed to be funded by tied aid need not always have better economic profitability indicators. However, if the higher price of goods/services confronting tied aid is more than offset generally by the lower financing cost, projects to be funded by tied aid would tend to have better profitability indicators. Those to be funded by tied grants would, of course, have even better profitability indicators than those projects to be funded by concessional loans. The softer the terms of aid, the greater would be the supply of investment projects with acceptable return, and the higher would be the recipient country's absorptive capacity.

Whether the above adjustments for go-no-go decision-making for each investment project and for ranking among projects would be acceptable to an aid-recipient country is a policy matter. If a substantial amount of aid is available but only for financing specific projects, the recipient country would have to make a policy decision as to how it will proceed to absorb it. One option would be to attempt to use it for projects of interest to the donor and to make the aforementioned adjustments in its investment decision-making process which might enhance its absorptive capacity for tied aid. Another option would be to treat such projects like any other and to disregard the financing terms altogether in the decision-making process. If those projects should prove to be unprofitable based on what is believed to be the OCC, the recipient could instead attempt to negotiate untying of the aid so that it becomes available for any project in the investment program which is deemed profitable and acceptable. If the negotiation for untying should be unsuccessful, that particular kind of aid, of course, would not be absorbed.

Whether donor agencies will accept project evaluations that explicitly account for the method of financing is also a policy matter that the donor must address. For instance, the donor might wish the recipient country not to treat a grant as a free good but rather value such funds at their market or opportunity cost. While a tied grant may not entail any economic or opportunity cost to the recipient, it certainly does to the donor.³³

Regardless of what way be considered by donors and recipients as an acceptable rate of return and abstracting from the source, terms and conditions of aid for investment financing, the rate of return on investment in a recipient country would be affected by the size of the domestic market and the extent to which the market functions efficiently and effectively. Due to diseconomies of small-scale operation, limitation of the domestic market would render many proposed investment projects unfeasible and unprofitable. A market which provides correct market signals and elicits rational economic response would also be important determinants of the extent to which productive investment opportunities are created and recognized by investment decision-makers both in the private and public sectors.

Relatedly, the degree of economic and political uncertainty as perceived by prospective donors would also affect absorptive capacity of a recipient country. When donors incorporate risk analysis in their evaluation of investment proposals, perceived economic/political uncertainties/risks in a country would

33. I am indebted to Professor Thomas Selden of the Maxwell School for calling attention to this point and to the broader issue of treating foreign aid in economic evaluation of investment projects when I presented the draft informally to the Maxwell (Metro studies) faculty. The source of funds for investment financing and whether and how they are repaid are generally disregarded in economic evaluation of investment projects. See, for instance, Warren C. Baum and Stokes M. Tolbert, *Investing in Development* (Fair Lawn, NJ: Oxford University Press, 1985), p. 430. One exception which explicitly addresses the issue is I.M.D. Little and J.A. Mirrlees, *Project Appraisal and Planning for Developing Countries* (New York: Basic Books, Inc., 1974), pp. 176-178.

tend to introduce a downward bias on the profitability of investment projects in that country.

Existence and pattern of an investment program (at least for the public sector) would also be a powerful determinant of absorptive capacity. The very existence of a public investment program (no matter how crude in terms of preparedness of projects contained therein and in terms of method used for project ranking and selection) would indicate that some thinking has been devoted towards identifying in a comprehensive manner possible investment opportunities in the public sector, even though the acceptability of many projects in terms of rate of return or of some alternative criteria has not been fully demonstrated. If the projects contained in the program were identified through comprehensive surveys of different economic sectors or geographic areas in terms of their development potential and constraints and there are indications of implementation timetable for each project, there would be some coherence in the investment program and complementarity of the projects constituting it. In turn, projects which are complementary and supportive of each other constituting a coherent program would have greater chances of yielding an economically profitable rate of return. For example, an investment in irrigation may not yield an acceptable rate of return if farm-to-market roads in the same project influence area are not constructed and put into operation in time when irrigation water becomes available. Without farm-to-market roads, farmers may not respond promptly, fully or at all in terms of increasing agricultural production to availability of irrigation water at affordable cost. Consequently, benefits in terms of increased agricultural production may not justify the cost of constructing a new irrigation system. Similarly, a farm-to-market road project alone may not be justifiable without the irrigation facility. Other examples of complementarity may be cited such as a huge investment in a power project yielding an acceptable rate

of return only if investment in a power-intensive industry, e.g., petrochemical, is simultaneously made.

Deliberate efforts at formulating a coherent investment program comprising projects which are complementary and whose timetable of implementation is carefully laid out would be worthwhile for recipient countries wishing to enhance their capacity to absorb foreign aid. However, formulating an investment program is one thing while implementing it is another. Because of multi-year duration in which investment projects are implemented, investment programs covering a specified duration (usually coinciding with a planning period of five years) would normally comprise: (1) projects which are on-going in terms of implementation; (2) those whose implementation has not commenced yet but whose acceptability in terms of rates of return or some alternative criteria has been demonstrated, on the basis of which a decision to implement has been taken; and (3) those which are newly identified, whose acceptability in terms of rates of return has not been established/confirmed but included in the program subject to passing certain tests of technical, financial and economic feasibility.

For projects in categories (1) and (2), their returns have presumably been found acceptable and, in the case of aid-funded projects, foreign assistance has presumably been programmed/earmarked to finance (partially or entirely) their implementation. To absorb aid which has been programmed for investment financing, the recipient country would need to continue implementing projects in category (1) and commence implementation of those in category (2). If aid is tied to specific projects and source of procurement, the ability of the recipient country to promptly absorb the aid would depend on its ability to implement projects in accordance with its own and the donor country's procurement procedures. Delays in project implementation or failure to initiate project implementation promptly or at all would necessarily result in delays or failure in absorbing foreign aid already

earmarked for specific projects. This is where a competent cadre of development managers would come in as an important and distinct group of civil servants. This group of professionals must possess both managerial and technical skills through formal training and more importantly through experience in the context of and as applied to development management, particularly its micro component, i.e., project management. These professional managers must have the ability to organize inputs coming from both recipient and donor governments, to translate them into outputs in accordance with procedures/restrictions imposed by both and be prepared to be held accountable by both governments. Indeed, the supply of the foregoing type of development managers is not particularly abundant especially in LDCs or even in aid-giving countries. If the bulk of development aid will continue to be tied to projects and to source of procurement, adequate supply of competent development managers possessing the aforementioned skills would continue to be an important determinant of foreign aid absorptive capacity.

The recipient country's ability to fully implement the investment program and to absorb foreign assistance earmarked to finance the program would also be influenced by its ability to demonstrate the feasibility of projects in category (3) above. Even though these projects were identified through systematic studies of development potentials and constraints of specific sectors/geographic areas, they would initially take the form of project concept or idea with very limited documentation as to their design, scope, specific location, etc. Skilled manpower would again be necessary to translate these project ideas in concrete terms. For each project, alternative designs may have to be looked into and their technical, financial (where appropriate), economic and operational feasibility will have to be assessed to determine the most feasible alternative, if any. For this purpose, what is commonly referred to as feasibility studies will be needed to provide basis for detailed documentation of the project's design, implementation schedule, scope,

estimated costs and expected benefits and for establishing its profitability in all aspects. This would be the kind of documentation that officials from planning and finance ministries of recipient countries and from prospective donor agencies would be looking for as basis for a go-no-go decision-taking.

Unfortunately, supply of skilled manpower to undertake project preparation, i.e., to conduct feasibility studies and/or to prepare the necessary documents for sound decision-making as to whether the project should be implemented/funded, is typically as scarce, if not more, as the supply of skilled manpower to undertake project implementation. This situation could be further aggravated by inadequate budgetary allocation for project preparation. Depending on the complexity of the proposed investment project, the cost of a feasibility study (excluding detailed engineering design) could go as high as 3 percent of total investment cost. If the need for careful project preparation to provide firm basis for sound decision-making is not fully appreciated by recipient governments, budgetary allocation for feasibility studies and other pre-investment activities would typically be grossly inadequate. Thus, even if expertise exists in the private sector within the recipient country, the public sector would be unable to tap said expertise due to local budgetary constraint. As noted earlier, part of foreign aid may then be used to finance pre-investment activities under this condition so that the bulk may be absorbed by recipient countries to finance their investment program. To enable the recipient country to use the expertise within its own private sector, donors would have to allow use of aid for local procurement of technical services. Whether donors would actually allow this is another matter as they may no longer view it as technical assistance. Since technical expertise exists and may be drawn from within the country's private sector, what is actually needed by the public sector is financial assistance to procure technical services for pre-investment activities within the country. One could argue that what is needed

is to promote greater appreciation by recipient governments of the need for thorough project preparation so that more budgetary resources are allocated for that purpose. Regardless of whether the resources for project preparation come from the recipient or from the donor, the point being made is that adequate supply of such resources is crucial in enhancing the capacity of recipient governments to implement their investment program, particularly projects therein which are foreign aid-funded, and thereby their capacity to absorb foreign aid.

While foreign aid from bilateral sources is typically a government-to-government transaction, the private sector's role in absorbing aid could go beyond supplying expertise which does not exist in-house within government. A good part of foreign aid could be absorbed by the profit-oriented private sector to finance economically and/or socially desirable investment but for one reason or another may not be financially profitable from the viewpoint of a private investor. This, however, would depend on the policy of the government of the recipient country with respect to the use of foreign aid. A government of a recipient country may consider foreign aid from another government or from an international financial institution as a resource which should be available exclusively or mainly to the public sector (including public corporations). It may adopt the view and the policy that if a proposed investment of a profit-seeking private sector is indeed profitable, the investor should be able to raise the necessary financing at prevailing commercial rates. There is, therefore, no justification for channeling foreign aid to the profit-oriented private sector for financing its investment.

Other governments, however, may have a more liberal policy with respect to the use of foreign aid made available for financing investment. Because of market distortions, some of which may be a consequence of deliberate government policies, some projects may not be financially viable but may be economically

desirable. To take a concrete example, a labor-intensive and export-oriented investment in garments may not be financially attractive because of high labor costs arising from a policy of prescribing minimum wages (in the face of massive unemployment) and may generate low financial returns arising from a policy of maintaining an overvalued domestic currency (in the face of persistent BOP deficits). Thus, the financial internal rate of return (FIRR) may be lower than the market rate of interest and the project is deemed financially unprofitable by the private investor. From an economic standpoint, however, this investment project would be most attractive because of its positive employment and BOP impact and would yield an EIRR greater than the opportunity cost of capital when labor and foreign exchange are shadow-priced. Recognizing these economic benefits, some governments may allow, if not actively encourage, use of foreign aid for financing private sector investment, particularly those whose financial and economic viability do not coincide as explained above.

The extent to which foreign aid will be absorbed by the profit-oriented private sector will, of course, depend on the extent to which concessionality of the terms of financing will be passed on by the recipient government and allowed by the donor/creditor. To make the project financially profitable to a private investor, it may be necessary to pass on to him most, if not all, of the concessionality. In some instances, it may even be necessary and justifiable for the recipient government to on-lend to the private sector the financial resources at a loss, depending on the size of the gap between financial and economic profitability. A good case can be made for a policy of allowing the private sector access to foreign aid and passing on to it the concessionality of the aid to the extent necessary to close the gap between economic and financial profitability.

If there is evidence that the public sector alone would be unable to absorb all of the foreign assistance made available for investment financing, a case can also

be made for channeling foreign aid even to commercially viable projects consistent with or supportive of government objectives and priorities at terms which are sufficiently attractive for private investors to avail themselves of the assistance rather than to obtain financing from normal commercial sources at market rates.

As shown above, the attitude and policy of the recipient country as to whether and to what extent the private sector will be given access to foreign aid would be a determinant of its absorptive capacity. The donors, however, may or may not share/agree with recipient's attitude/policy. The attitude and policy of donors on the matter could also vary. While most donors may allow a portion of their official development assistance to be channeled to the private sector, some may not want to see the concessionality of aid passed on to private sector recipients. For example, the U.S. which provides assistance mostly in grants and in extremely concessional loans to the Philippines prefers, as a matter of policy, that it be made available to the private sector at market rates, thereby allowing the government to keep most if not all of the concessionality and preventing undue distortion of the financial market. Japan, on the other hand, which provides its concessional loan through the Overseas Economic Cooperation Fund (OECF) at around 3 percent per annum encourages on-lending rates to the private sector at below market rates to justify it as ODA in cases where OECF loan proceeds are channeled to the private sector. Otherwise, the loan may not be justifiable as an OECF loan with a concessional rate of interest and may be justifiable only if provided through the Japanese Eximbank at a higher rate of interest. Donor countries which deliberately use part of their ODA to help their suppliers in making competitive bids not only require that it be tied to the source of procurement and to a project. In addition, they require that concessionality is fully passed on to the ultimate recipient to enable their suppliers to gain competitive

advantage in terms of lower financing cost over other suppliers whose governments do not offer CDA at the same terms.³⁴ Similarly, the recipients may or may not share/agree with the donor's attitude/policy on this matter. In the final analysis, it would be the ability of both parties concerned to find a common ground and agree on whether and how foreign aid may be used by the private sector that will determine whether or not the profit-seeking private sector would have a significant role in enhancing a recipient country's capacity to absorb foreign aid. The role of nonprofit or service-oriented private sector has been deliberately avoided so far as the analysis has been confined to determinants of absorptive capacity with respect to foreign aid restricted to investment financing. Its role will be discussed fully in the next section where determinants of absorptive capacity for aid available for investment financing and/or for other purposes are analyzed.

Aid Available for Investment Financing and/or for Other Purposes

In the preceding section, discussion of the determinants of absorptive capacity was confined to foreign aid available for investment financing only. It was shown that most determinants relate to the ability of the recipient country to generate productive investment opportunities, to recognize those opportunities by identifying specific investment projects, to demonstrate the feasibility and desirability of such projects through adequate project preparation, to convince itself and the prospective donors that the projects or the entire investment program would yield some acceptable economic or social return based on

34. Use of foreign aid as an instrument to promote exports is reportedly increasing. In a report prepared by US Eximbank, U.S. industry is losing \$1 billion a year because other governments are increasingly using foreign aid as an instrument to promote exports. See Clyde Farnsworth, "\$1 Billion Annual Export Loss Seen," *New York Times* (April 21, 1989):D9.

mutually agreed upon standards, and to implement the investment program and projects so that foreign aid earmarked for their implementation are disbursed and thereby absorbed by the recipient country. When aid is available not only for investment financing but also for other purposes earlier mentioned, other factors not necessarily related to the country's ability to generate, recognize and demonstrate investment opportunities come into play.

When there is a wide range of possibilities for using foreign aid, the effectiveness of the entire machinery of government for aid administration and for development administration in general becomes more important as a factor affecting a country's capacity to absorb aid. The effectiveness of the aid administrative machinery would partly depend on: (a) the efficacy of the structure by which the government is organized for development and aid administration; and (b) the adequacy of the staff manning the organization in terms of both quantity and quality at the managerial and technical levels who operate based on simple, flexible, expeditious but nonetheless rational policy-making and decision-taking processes for aid allocation among competing claims and alternative uses. The efficacy of the organizational structure for aid administration would in turn partly depend on whether: (a) it conforms with the manner in which functions are differentiated; (b) the responsibility and authority for carrying out the functions so differentiated are clearly delineated among various administrative units and officials; and (c) the mechanism for coordinating the planning and execution of activities pursuant to each differentiated function by various agencies concerned towards achieving a common objective of efficient and effective aid utilization actually works.

In aid-recipient countries, there are typically four (4) groups of actors involved in aid administration, as follows: (a) those who raise or generate the resources; (b) those who allocate them; (c) those who use them, and (d) those

who regulate and monitor their use. Table III-1 below offers one way in which functions relating to aid administration might be broadly differentiated and how responsibilities for carrying out such functions might be neatly assigned and delineated among various actors. Based on their inherent functions and role in government, it would be logical to assign to foreign affairs and finance departments the function of generating foreign aid as the task relates to the conduct of the recipient country's foreign affairs and to the raising of government revenues, respectively. Aid allocation would also be logically assigned to planning departments, aid being a significant source of financing the investment, foreign exchange, and technical assistance requirements of the development plan and in view of the fact that development planning is essentially a resource allocation exercise. Budget departments' role in aid allocation would be justifiable in terms of annual budgeting of line agency expenditures chargeable against proceeds from foreign aid. To ensure financial accountability in the use of foreign aid, the auditing office would need to regulate its use by prescribing certain accounting and auditing rules and regulations. Central banks, because of their concern over monetary and BOP impact of aid on internal and external stability of the domestic currency, would have to exercise certain regulatory powers. The rest of the actors participate in the aid administrative process as ultimate recipient and user of foreign aid generated, allocated and regulated by previously cited agencies. The role of each entity in carrying out the four differentiated functions is neatly delineated in Table III-1 with the (/) mark.

To further delineate responsibility in aid generation, foreign affairs could be given primary responsibility for grants and finance for concessional loans. In aid allocation, planning could take responsibility for broad allocation among alternative uses, i.e., investment financing, etc., for more specific allocation among competing projects, and for medium-term (five year) programming or

scheduling of aid use. Budget could confine itself to annual programming in conjunction with its annual budgeting of agency expenditures, both capital and current operating. While the foregoing delineations of functions may be ideal and logical in principle, it may hardly happen in practice. For example, both foreign affairs and finance may feel that it should have principal responsibility for aid generation regardless of the terms of assistance, i.e., whether grants or loans. Thus, both may represent as having the authority to deal with donors. Because of its primary responsibility for aid allocation and programming, planning may also tend to assume responsibility of generating it and to also represent the government in dealing with donors. State corporations authorized by their charters to directly contract foreign loans or receive grants may also deal directly with donors. And so are PVOs/NGOs and local governments.

TABLE III-1 Functional Differentiation of Aid Administration and Role of Various Entities				
Agencies	Function			
	Generate	Allocate	Use	Regulate/Monitor
Foreign Affairs	/	•		
Finance	/	•	•	
Planning	•	/		•
Budget		/		•
Auditing				/
Central Bank	•	•	•	/
Implementing Line Departments			/	
State Corporations	•		/	
Private Corporations	•		/	
PVOs/NGOs	•		/	
Local Governments	•		/	

In the matter of aid allocation, the same situation may prevail, whereby, for one reason or another, foreign affairs, finance and central bank may try to influence if not directly usurp the aid allocation function of the agencies duly

authorized and assigned to carry out such function. This chaotic situation is depicted in Table III-1 by the (*) mark. Often, donors would have to figure out which agencies of the recipient country are theoretically responsible for what function, which agency is actually and effectively exercising a particular function, and to deal with each of them accordingly.

Even assuming that the functions are properly differentiated and clearly delineated, there remains the task of installing an appropriate machinery for coordinating the exercise of such functions assigned to different agencies. Short of establishing a Department of Aid Administration, the problem of coordination of aid administration would be typically addressed by the establishment of a council or a cabinet or sub-cabinet-level coordinating committee whose members are drawn from the concerned entities. Being a collegial body, the policy-making and decision-taking processes regarding aid allocation, programming and use would necessarily be somewhat more complex and time-consuming. It is nonetheless more democratic and would be more responsive to the needs/concerns of interest groups whose representatives perform effectively in democratic processes. Certainly, there is a tradeoff between timeliness and quality of a decision regarding aid allocation. And it would be incumbent on a recipient country's government to strike a proper balance between timeliness and efficiency in aid use depending on the extent, terms and conditions of aid availability.

If responsibility and authority for carrying out various functions are not clearly delineated and officials representing various agencies comprising the aid administration system have strong and conflicting views as regards their role, the task of coordinating actions of such agencies toward achieving a common goal of aid absorption would obviously be even more difficult and the decision-taking process more complex and time-consuming. Fierce bureaucratic rivalry and

bickering would likely characterize the aid programming and negotiation process. In the end, delivery of aid would be delayed, if it is not lost.

An aid administrative machinery is effective only to the extent that aid pledged or announced to be available by donors is actually availed of or absorbed promptly, expeditiously and efficiently in support of the recipient country's development objectives and priorities *but* in light of donors' policies and procedures. For the aid administrative system of a recipient country to be effective, it must develop and adopt an aid utilization policy which all actors must adhere to, premised on the principle that aid must be used in support of the recipient country's development objective and priorities but tempered by recognition that aid is given by donors in accordance with their own policies and procedures primarily designed to promote their respective national interests. The aid utilization policy should as much as possible be translated in operational terms, preferably in terms of its role/share in financing the development plan, including the public investment program, but allowing for some flexibility to accommodate unforeseen needs and changes in the development environment.

Donors' policies and procedures must also be known to all actors concerned in the recipient country for their guidance and, more importantly, for their appreciation of the fact that such policies and procedures must be either complied with or negotiated away for aid pledges to become actual aid flows. Once again, it would be incumbent upon the recipient country to determine, on a case-by-case basis, when it should simply comply with those policies and procedures and when it should try to negotiate, how hard and to what extent it can and should compromise its own policies and procedures, if not its principles as a sovereign state. There are many factors to consider like the magnitude of the resource gap and the external financing gap to be filled by foreign aid in order to achieve growth targets, the thinness and length of the project development pipeline, the

extent to which "policy reforms" are being linked to aid and the relationship between aid absorption now and aid availability in the future.

Recipient countries can only compromise so much in the interest of absorbing aid for development as they are also sovereign states whose government is accountable to their own people. Therefore, the extent to which donors would be sensitive and responsive to the needs identified and perceived by the recipient country and be prepared to subordinate their political, strategic or commercial interests would also be a determinant as to whether aid which they pledge to a recipient country will, in fact, be absorbed. We shall return to this point when specific policies of donors in aid-giving are discussed later.

Let us now consider a case where foreign aid available to a recipient country for a five-year period may be used for either investment financing (capital assistance) or technical assistance in the public sector only. For simplicity, other aid forms like debt relief, commodity imports, etc. are assumed away, for the time being. The first decision point to be dealt with by the aid administrative system would be the allocation between capital and technical assistance. If technical assistance is intended entirely for pre-investment activities, i.e., project identification and preparation, and for project management/supervision, aid for technical assistance may be used in conjunction with the formulation and implementation of the public investment program. Like capital assistance, programming of the use of technical assistance may be linked to the formulation and implementation of a public investment program. Priorities for capital and technical assistance would therefore coincide. However, if technical assistance can be used for general institution building, i.e., creating new institutions or strengthening those already existing or for research and development (R & D), a separate set of priorities for technical assistance would have to be established and a technical assistance program formulated accordingly, if ad-hoc or arbitrary use

of aid for technical assistance purposes is to be avoided. The ability of the aid administrative machinery to formulate a technical assistance program acceptable to the political leadership under democratic conditions would depend on its ability to harmonize and reconcile competing claims among line departments of central government and between central and local government units and to establish priorities among such claims based on some set of criteria.

To absorb aid available for technical assistance, the program would have to be implemented. For this purpose, the aid administrative system must be able to concretely define the technical assistance needs of specific agencies and to document it in a form and substance acceptable to the donors (which may vary) and to the decision-making authorities in the recipient country in the first instance (which may be more difficult). Because technical assistance projects usually involve relatively small amounts of aid compared to capital assistance projects, absorption of aid for technical assistance normally involves preparation and implementation of a large number of projects and therefore a large number of civil servants who must be knowledgeable about appraisal standards and methods, procurement procedures and restrictions imposed in their own country and in the donor countries. Since a recipient country is typically confronted with multiple sources of foreign aid, project managers and staff must be prepared to deal with a variety of appraisal standards/methods and procurement procedures/restrictions each of which needs to be reconciled with those in the recipient country.

Considering the number of foreign-assisted projects (including capital assistance) and the number of aid donors operating in a recipient country, the administrative burden occasioned by aid tied to specific projects could be a significant factor limiting the capacity to absorb that kind of foreign aid.

There are many horror stories on administrative overload which are cited in the literature. One author who wrote in defense of foreign aid reported that, in 1984, Peru received aid from 22 bilateral and multilateral donors, Kenya from 25 and India from 31, each of which

- in the interests of management efficiency and accountability to its own taxpayers, wishes at the very least to apply an economic, technical and financial appraisal to suggested projects, before they start; to engage in subsequent negotiations concerning location, technical specification, training of counterpart staff, phasing of financial contributions and very possibly aspects of the "policy environment" such as product prices, rail rates, subsidies and commercial policy; to monitor progress throughout the project, involving the setting up of complex statistical-reporting systems; and to evaluate the project at the end of disbursement and possibly a few years afterwards as well. Even for a generously staffed and highly trained organization, which a very poor country by the nature of the case does not possess, this is a great deal of work.³⁵

By latest count (March 1989), the Philippines has a total of 9 multilateral sources and 15 bilateral sources of foreign aid, or a combined total of 24. Based on my own personal experience in dealing with those foreign aid sources, most of the tasks quoted above, in fact, had to be performed at least in the case of capital-assistance projects. In addition, a great deal of documentation had to be prepared from the time that a project idea was conceived and prior to appraisal.

Staff time spent to perform the above-cited tasks would probably be worthwhile if, in fact, they resulted in timely appraisal and implementation of projects which contributed to achievement of development objectives in the process of aid absorption. Even more disturbing, however, is another report that

- in East Africa some of the most talented local personnel were tied up greeting, meeting and generally satisfying donor curiosity, whims, regulations and performance criteria.³⁶

35. Paul Mosley, *Foreign Aid, Its Defense and Reform* (Kentucky: University Press of Kentucky, 1987), p. 100.

36. *Ibid.*, page 101.

Similarly disturbing is the way in which another author described how donor and project proliferation is affecting the aid administrative machinery in Sub-Saharan African countries. Noting that there were 82 organizations (including 15 NGOs) providing significant amounts of development assistance to African countries, the author attempted to show how the proliferation of donors and the expansion of project assistance imposed heavy burdens on recipient countries and how these burdens "have contributed to institutional destruction."³⁷

While the foregoing impact of numerous donors/projects in terms of "institutional destruction" may be somewhat exaggerated, there is some validity in the argument made that when foreign-assisted project managers are expatriates, they "become answerable to donors rather than to the government of the developing country."³⁸ Institutional destruction occurs, it was argued, when lines of authority are further blurred as a consequence of conflicting loyalties experienced by the expatriate project manager. So much for foreign aid available only in the form of project assistance.

Let us now relax somewhat our assumptions and consider foreign aid *also* available in other forms, i.e., for financing of current imports and government current operating expenditures, debt relief, food aid, and delivery of social services directly to the people by the nonprofit-seeking private sector, commonly referred to as private voluntary organizations (PVOs) or nongovernment organizations (NGOs).

As our assumptions are relaxed and other forms of aid emerge, the already burdened aid administrative machinery is confronted with an even more enormous and complex task. It will be recalled that the first allocation decision

37. Elliott R. Moss, "Institutional Destruction Resulting from Donor and Project Proliferation in Sub-Saharan African Countries," *World Development*, 12,4 (1984):466.

38. *Ibid.*, p. 647.

under previous assumptions was only between capital assistance and technical assistance in the public sector. Now, the aid administrative machinery must also determine whether and how much aid should be channeled to the private sector for investment financing and for delivery of social services through nongovernmental organizations. Policies regarding terms and conditions of on-lending to the profit-seeking private sector would need to be formulated and decisions on specific private sector investment financing proposals accordingly taken. For the service-oriented private sector represented by PVOs/NGOs, policies as to terms and conditions for channeling aid to the sector would also need to be formulated and actions on specific proposals taken as well.

Often, the policy as to whether and how aid should be directed towards PVOs and NGOs would depend on the attitude of governments towards PVOs/NGOs. While donor countries may view them as a useful alternative conduit for delivering aid to a people, some governments of recipient countries may not want to see a significant portion, if any, of foreign aid, being channeled through PVOs/NGOs. A government may look at PVOs/NGOs as competitors in the delivery of social services to its people and even as instruments which may help bring it down from power. However, some may have a more positive attitude and may consider PVOs/NGOs as partners in the pursuit of development, particularly in the delivery of basic social services. For this latter attitude and policy of a recipient government towards PVOs/NGOs to be present, that government must enjoy the full confidence of its people and recognize the competence and relative strength of PVOs/NGOs as change agent at the grassroots level. The comparative advantages of NGOs over governmental entities in social services delivery often cited are their ability to take quick action due to absence of a large bureaucracy to deal with, their acceptability to the

beneficiaries as they are perceived to be politically neutral change agents, and the sheer determination and dedication of their staff in what they do.

In a situation where a good portion of aid can be used for delivery of basic social services such as in health, nutrition, family planning, etc., but is not being used fully due to limitation of staff and other complementary inputs from government, NGOs can play a significant role in the ability of a recipient country to absorb aid. This role of NGOs, however, is limited by the fact that they have their own absorptive capacity limits and that the mechanism for aid absorption is through project assistance which is relatively more time-consuming.

For that portion of aid to be absorbed through the public sector, the aid administrative system must deal with and resolve the issue of alternative uses and must negotiate an aid utilization package acceptable to donors. This is particularly complex not only because there are various interest groups within the public sector who would bat for a particular aid utilization package but also because aid would typically come from a multitude of donors who may have different motivations in aid giving and would therefore have varying level of restrictions with respect to form and tying. For example, in the interest of timely and effective implementation of the public investment program, public corporations and infrastructure and other agencies of government involved in capital formation in the public sector would naturally push for public investment financing as the principal means of aid utilization. If attainment of growth targets hinges primarily on a successful implementation of the investment program, the planning department would most likely support this option. If there is large deficit in the BOP and in the budget, other groups (most likely from Finance Department and Central Bank) would naturally push for financing of current imports and current consumption in the interest of immediate inflow of foreign exchange. Depending on the extent to which policy conditions associated with nonproject assistance are

imposed by donors and on whether certain officials in the recipient country consider these conditions as an encroachment into the prerogatives of a sovereign state, such officials may or may not be in favor of nonproject assistance, notwithstanding its relatively quicker-disbursing nature.

In the process of cranking out an aid utilization package, the aid administrative system must reconcile its preferred pattern of aid utilization with the policies and procedures of each donor and therefore negotiate with each of them before a mutually acceptable aid utilization package could come into being. This whole process of finding a mutually acceptable pattern of aid utilization can already take a lot of time. Actually absorbing the aid based on such pattern can take even much more.

Donors' Motivation, Policies and Procedures

Aid may be delivered in different forms and with varying levels of restriction depending on the underlying motivation of the donor in aid-giving. The form in which aid is delivered and the extent to which restrictions are imposed by the donor with respect to its utilization would greatly affect the recipient's ability to use it. Donors' motivation in aid-giving would therefore be a major determinant of the capacity of the recipient to absorb it.

The literature³⁹ on foreign aid identified two sets of motivation in aid-giving. The first is that aid is given by donors primarily to promote their own political,

39. See, for instance, John White, *The Politics of Foreign Aid* (New York: St. Martin's Press, Inc., 1974).

security and commercial interests. The second is that aid is given to genuinely promote economic development of recipient countries or for humanitarian reasons as in the case of food aid following a disaster. Some⁴⁰ argue that the two motivations need not be in conflict and may be complementary. The economic justification for foreign aid is eminently documented in the literature particularly in terms of the two-gap model⁴¹ developed by Chenery and his two cohorts, Bruno and Strout. Even though the evidence on the relationship between aid and economic growth is not conclusive, there is popular acceptance that aid is necessary to reduce or close the resource gap or the foreign exchange gap constraining the growth of recipient countries in the early stages of their development. While there seems to be consensus on the economic justification for foreign aid, the underlying motivation of donors in aid-giving is still subject to much debate. There is some evidence, however, that bilateral sources make their aid allocation decisions to promote their own interests while multilateral sources make theirs to genuinely promote the development of recipient countries. One empirical research on aid motivations concluded that

bilateral aid allocations are made largely or solely in support of donors' perceived foreign economic, political and security interests. By contrast, aid flows from multilateral sources, as would be expected, are allocated essentially on recipient need criteria.⁴²

Motivations of donors for giving aid affect the capacity of recipients to absorb aid because the form in which aid is delivered and the corresponding restrictions imposed for using it would largely depend on the motivation of the

40. See, for instance, Anne Krueger, "Aid in the Development Process," *Research Observer*, 1 (January 1986).

41. See Hollis B. Chenery and Michael Bruno, "Development Alternatives in an Open Economy," *Economic Journal*, 77,285 (1962):79-103, and Hollis B. Chenery and Alan Strout, "Foreign Assistance and Economic Development," pp. 679-733.

42. Alfred Maizels and Machiko K. Nissanke, "Motivations for Aid to Developing Countries," *World Development*, 12,9 (1984):891.

donor. For example, if the donor's motivation is essentially to promote its security interest, e.g., aid is given in exchange for rights on military bases, or its political interest, e.g., aid is given to gain vote in an international forum, it may provide aid in the form of budget support and waive its policy of tying aid to specific investment projects in the interest of timeliness in aid flow. It may agree further to transfer the financial resources as free foreign exchange whose local currency proceeds may be used by the recipient government even for financing current operating expenditures. Since this form of aid is not tied to any specific project with a minimum expected EIRR, the capacity of the country to absorb it need not be limited by the availability of "good" projects with acceptable expected EIRR. Rather, the capacity of the country to absorb it would largely depend on the "need" for foreign exchange or foreign savings and the ability of the government to demonstrate and justify that need in terms of a foreign exchange gap or a resource gap needed to be closed to achieve a reasonable economic growth target.

If the donor's motivation is largely to promote its commercial interest, it is likely that aid would be tied to the country with respect to procurement. The form in which aid should be logically delivered would be a commodity loan/grant, i.e., aid would be available to procure any commodity from the donor country. As before, availability of "good projects" would not set the limit to the capacity to absorb aid.

If promotion of development of the recipient country is the genuine motivation of the donor and a domestic savings-investment gap is identified as the dominant constraint to development, it would be reasonable to expect that aid would be made available to finance specific investment projects or any portion of the public investment program (either a sector or a time slice) without any restriction as to the source of procurement. Any project, therefore, with an

acceptable EIRR which is included in the public investment program would be eligible for aid financing regardless of the composition of the cost between equipment/materials and labor. To the extent that the donor has confidence in the integrity of the recipient's investment program in the sense that the projects constituting the program have been tested in terms of their technical/economic feasibility, aid can be made available to partially cover the cost of the program, regardless of the source of procurement, kind of inputs (equipment, material, labor) or sectoral orientation of the projects.

In the likely event that the donor would also want to promote its commercial interest (to respond to its constituency's demand) in the process of promoting the development of the recipient country, restrictions in the use of aid would tend to emerge. Since there are multiple objectives, multiple tying of aid becomes necessary. First, aid would have to be tied to specific projects to ensure that assistance is channeled to those whose expected EIRR are deemed acceptable. Second, it would have to be tied to foreign exchange cost of projects whose input requirements need to be sourced from abroad in substantial quantities. Third, aid would have to be tied to the donor country with respect to procurement to realize the commercial objective regardless of the price competitiveness of project inputs to be supplied from the donor country. Indeed, this triple-tying of aid to projects, to the project's foreign exchange cost and to the source of procurement is the most prevalent aid delivery mechanism from bilateral sources. This would tend to lend support to the proposition that bilateral donors do want to help themselves primarily in the process of aid-giving.

When aid is tied to specific investment projects and to source of procurement, the capacity of the recipient country to absorb it becomes limited in the first instance by the supply of projects whose expected EIRR is mutually acceptable to donor and recipient. Secondly, those projects must have substantial

import content, and thirdly, equipment/materials to be imported must be available in the donor country. Furthermore, the recipient country must be prepared to forego maximum value of the assistance as a result of multiple aid-tying to the project, to foreign exchange cost, and to the source of procurement.⁴³

Apart from the reduction in the value of aid from the point of view of the recipient country, one other adverse consequence of limiting the use of aid to cover foreign exchange cost or imported inputs must be pointed out at this juncture. Because of this form of aid tying, the investment program would tend to be more import dependent than it would be if aid were untied. Because of its negative effect on the balance of payments, aid tying with respect to procurement would seem to defeat one of the two fundamental economic objectives of aid in the two-gap model, i.e., to reduce or close the foreign exchange gap. An aid practitioner from a donor country observed that "availability of project financing for only foreign exchange costs causes the priorities of recipient countries to almost invisibly rearrange themselves around foreign-exchange component of any desired project. Thus, although development financing at concessional terms is supposed to help recipient countries overcome their foreign exchange scarcity, the form of the financing nevertheless creates an incentive to increase unnecessarily the demand for that scarce exchange."⁴⁴

As an aid practitioner from a recipient country, I cannot agree more with the foregoing observation. Indeed, there were instances when projects in the

43. Studies have shown that aid-tying reduces the value of aid between 20 and 25 percent on the average. See White, *The Politics of Foreign Aid*, p. 161. See, also J. Bhagwati, "The Tying of Aid," in J. Bhagwati and R. Eckaus (eds.), *Foreign Aid* (New York: Penguin Books, 1970), pp. 235-293. More recently, Chenery reported that when compared with competitive bidding, bilateral aid-tying reduces aid value by 25 percent or more. See H. Chenery, "Foreign Aid" in John Eatwell, Murray Millgate and Peter Newman (eds.), *Economic Development* (New York: W.W. Norton, 1989), p. 141.

44. Judith Tandler, *Inside Foreign Aid*, p. 74.

investment program did not elicit interest from bilateral donors, not because they are not feasible but because the foreign exchange cost of materials/supplies/equipment potentially available in the donor country is insignificant. There were other instances when an aid-using and project implementing agency would propose an otherwise low-priority project (but with a high foreign exchange cost component) for inclusion in the investment program and for foreign funding assistance because of good prospects of eliciting interest from bilateral donors. The pattern of the investment program would consequently be distorted in the sense that projects would tend to contain a larger foreign exchange component of total cost, be less complementary with each other, and have lower profitability ratios. The entire investment program therefore becomes less coherent, more foreign exchange intensive, less efficient in the use of total (domestic and foreign) resources and would have lower growth impact as a consequence of multiple aid-tying and other restrictions in aid use.

If the donor's objective behind aid tying is purely commercial, procurement-tying should suffice without project-tying at the same time. In the first place, it would pose less administrative burden to the donor. Secondly, it would be less disadvantageous to the recipient as it would have the opportunity to select the commodity, equipment or service in which the donor is more internationally competitive, price-wise and quality-wise. Once aid is also tied to a project or to a commodity, the recipient country may actually receive substantially less aid in terms of additional real resources than the face value of the aid depending on: (a) grant element of the aid which is a function of the rate of interest, maturity period and grace period; and (b) the price at which commodity/equipment is purchased in the donor country relative to world price. If the grant element is minimal and the price at which the commodity is sold in the donor country is much higher relative to the world price, the real resource

transfer may approach zero or even negative. Multiple tying of aid can result in negative real aid and therefore no aid can be better than any aid.¹⁵

If the donor's objective, on the other hand, is to promote development of the recipient by financing partially its investment program, it should satisfy itself with the integrity and coherence of the entire program rather than with the profitability of each project in the program. Project-tying of aid by donors need not achieve its intended purpose of funding the project to which aid is tied because of the fact that funds are fungible. If a donor provides aid on condition that it can be used only for a specific project (because in its judgment it is the project which yields maximum return and/or because the project would entail importation of goods and services from itself), it is possible that what the aid will actually fund is precisely what the donor did not intend to fund. This possibility exists if the recipient has some resources of its own, the project to which aid is tied is profitable from the viewpoint of the recipient, and it would have been implemented with or without aid. Because of fungibility of funds, domestic

45. For a more detailed explanation and illustration of how aid is calculated as a real additional resource from the standpoint of a recipient, see White, *The Politics of Foreign Aid*, pp. 162-164. The formula for computing "real aid" is as follows:

$$\text{Real Aid} = \frac{\text{Face Value of Aid}}{\text{Donor Price Index}} - \text{Payment Equivalent}$$

where

$$\text{Donor Price Index} = \frac{\text{Price in Donor Country}}{\text{World Price}}$$

$$\text{Payment Equivalent} = \text{Present Value of Interest Payment and Amortization of Principal}$$

The difference between the face value of aid and the payment equivalent would be the grant equivalent. When expressed as a percentage of face value, the grant equivalent is referred to as the grant element. To illustrate, a loan with a face value of \$1 million and a grant element of 25 percent but tied to the donor country with respect to procurement, where the price is 50 percent higher than the world price, would have a grant equivalent of \$250,000, a payment equivalent of \$750,000 and a donor price index of 1.5. Thus,

$$\text{Real Aid} = \frac{1,000,000}{1.5} - 750,000 = -83,330$$

Reduction in real value of aid when provided in loans tied to projects, commodities and source of procurement was brought out earlier by Harry G. Johnson, *Economic Policies Towards Less Developed Countries* (Washington, DC: The Brookings Institution, 1967), p. 124.

resources may be liberated as a result of aid from the project to which aid is tied so as to allow implementation of another project which the donor did not consider profitable and did not wish to fund. Furthermore, the recipient may exercise other options in the use of liberated funds and may use them to increase consumption. As a result of the additional resource, the recipient may also opt to reduce savings while maintaining both the level of investment or consumption.

Aid tying to a specific project promotes the donor's commercial interest, not by ensuring the project's implementation because it would have been implemented in any case, but by ensuring that procurement is sourced from the donor country. But this would have been achieved by straightforward procurement-tying. Project-tying may be ineffective because "the project actually financed by aid may be quite different from one to which the aid is ostensibly tied."¹⁶ In short, if the underlying objective is to serve the donor's commercial interest, procurement-tying is a more sensible and straight forward instrument rather than project-tying. If the genuine motivation for aid-giving is to assist in investment financing as a means of promoting growth of recipient country, aid should be linked to the entire investment program rather than just to a project or a set of projects.

It is seen from the foregoing that different motivations and combinations thereof could affect the form in which aid is given and the restrictions or degree of aid-tying imposed. In turn, the form in which aid is actually made available and the restrictions imposed by the donor obviously affect the recipient country's ability to use it.

Related to the issue of tying aid to a project or linking it to a program is the matter of local-cost financing. As pointed out earlier, if aid is primarily intended

46. H.W. Singer, "External Aid: For Plans or Projects?" in Jagdish Bhagwati and Richard Eckaus (eds.), *Foreign Aid* (New York: Penguin, 1970), p. 294.

to help finance a country's investment program or a development plan, it should not be confined to financing of foreign exchange costs. Typically, however, aid is available only to cover foreign exchange costs. The extent to which aid can be used to cover local currency cost would partly determine absorptive capacity particularly in the case of recipient countries whose development strategy is anchored on the pursuit of rural development programs, small-scale industries and labor-intensive rural infrastructures. The investment program associated with these activities would typically require less imported inputs and higher proportion of local currency cost.

Depending on the socioeconomic and political conditions in a recipient country, aid may be provided in grants, very concessional loans or not so concessional loans. In the case of multilateral financial institutions, the recipient country's per capita income, among others, is used as criterion for determining its eligibility for credit through its most concessional window, e.g., credit from the International Development Association (IDA) in the case of the World Bank Group which is interest free and from the Asian Development Fund (ADF) in the case of the Asian Development Bank. In the case of bilateral sources, political conditions may determine the terms of aid. In the Philippines, for example, all committed but still undisbursed loans were forgiven, i.e., converted from loans to grants, shortly after the change of government in 1986.

Due to its obvious implications on debt servicing, a recipient country which is suffering already from a heavy debt service burden would tend to be more discriminating in the sourcing of foreign aid. Grants, would, of course, be generally preferable. The remaining considerations would be the extent to which it is tied with respect to end-use and to procurement and the price of the commodity in the donor country relative to world price. As the terms of aid become harder, both the ability and willingness of the recipient country to absorb

it will decline. Even if the terms of a loan are soft and the grant equivalent is high, the fact of the matter is that it is a loan and there is a payment equivalent. If it is tied to procurement from a donor country, the recipient would have to figure out the amount of real aid in terms of addition to resources by considering both the grant equivalent and the price at which it is able to obtain real resources from the donor country relative to the world price.

When a recipient country is faced with a heavy debt service burden and has already reached the stage where the flow of resources from its creditors has been reversed, i.e., there is a negative net resource transfer, absorption of aid in the form of loans becomes more a matter of willingness than ability.

To illustrate, let us consider a situation where alternative sources A and B of loan financing are available for a typical infrastructure project, say, in power. Both are tied to the project. Source A is tied to a country with respect to source of procurement but offers extremely concessional financing. Source B is untied and requires international competitive procurement, allows 50 percent of loan proceeds to be used for local cost financing but offers relatively less concessional financing. There are three factors to consider in the decision making process, namely: (a) the grant element of the loan which is a function of the terms of the loan; (b) the ratio of the price of power equipment and engineering services in Source A to the world price (donor price index); and (c) the recipient country's need for free foreign exchange.

Let us look at some numbers to facilitate analysis of the decision-making process for aid sourcing (see Table III-2).

TABLE III-2 Terms of Aid and Real Aid		
	Source A	Source B
Loan Amount (Face Value)	\$1,000,000	\$1,000,000
Grant Element	75%	25%
Grant Equivalent	750,000	250,000
Payment Equivalent	250,000	750,000
Donor Price Index	1.6	1.0
Deflated Face Value	625,000	1,000,000
Real Aid	375,000	250,000

Under Source A, note that aid is extremely concessional with a grant element of 75 percent and therefore a grant equivalent of \$750,000 and a payment equivalent of \$250,000. However, since aid is tied to source of procurement and price of power equipment and engineering services in Source A is 60 percent higher than the world competitive price, the nominal or face value of aid should be deflated. Following the formula for computing real aid as the difference between the deflated face value less the payment equivalent, real aid is computed at \$375,000. Under Source B, the terms are less concessional so that the grant element is only 25 percent or a grant equivalent of \$250,000 and payment equivalent of \$750,000. Since aid is not tied and subject to international competitive bidding, project inputs will be procured at world competitive price. Therefore, the nominal face value is equal to the deflated face value. However, because the grant element is low, real aid comes down to only \$250,000. Source A is therefore preferable over B from the standpoint of magnitude of real aid.

Recall, however, that there is a third factor to consider, namely, need for free foreign exchange, which is a function of the BOP deficit. In a heavily indebted country, this deficit would be accounted for largely by the debt service burden. Recall further that under Source B, 50 percent of loan proceeds may be used for local cost financing. This means, in effect, that 50 percent of the loan is free foreign exchange in the sense that its inflow under the BOP capital account need not be accompanied by an outflow in the current account as a result of the

project's implementation. This part of the loan can therefore be used for financing other expenditure items in the current account, e.g., interest payments, or in the capital account, e.g., amortization of principal. While inflow of foreign exchange under the capital account from aid intended for local cost financing is tied to the project's implementation, there need not be a corresponding outflow under the current account. The additional foreign exchange may therefore be used for purposes other than the project's implementation. Thus, it is "free" foreign exchange. On the contrary, both inflow and outflow of foreign exchange arising from aid intended for foreign currency cost financing of a project are tied to its implementation.

Other things being equal, aid which brings in free foreign exchange would be preferable than one which does not. Going back to our example, Source B would have been preferable because it would bring in free foreign exchange if real aid from both sources had been equal. If the Donor Price Index under Source A had been 2.0 rather than 1.6, i.e., price of power equipment/services had been 100 percent more or twice as expensive than if it were procured through international competitive bidding, the real value of aid from Source A would decline from \$375,000 to \$250,000. Since real aid from A and B would now be equal, the recipient country would prefer aid from B *rather than* from A. Willingness and ability to absorb aid from A *in addition* to aid from B would depend on the availability of other projects acceptable to A or willingness of A to provide aid other than through the project mechanism.

Because of the need for free foreign exchange and the relative ease with which aid may be disbursed when provided outside of the project mechanism, nonproject, e.g., structural adjustment loan, budget support grant, etc., is generally preferred by recipient countries over project aid.

Unless aid is provided entirely in the form of grants, an aid recipient country would eventually reach a stage of reversal in aid flows, i.e., inflows from new aid are less than outflows for debt service. The time within which a reversed net resource transfer situation is reached and the magnitude of the negative transfer would essentially depend on: (a) the terms of past aid; (b) availability and terms of new aid; and (c) the ability and willingness of the recipient country to generate a surplus either by increasing savings and exports or by reducing investment and imports to service outstanding debt.

There are now many countries suffering from excessive debt servicing burden (e.g., Philippines) and, as a consequence, have ceased to become a net recipient of resources. These countries are now in a situation of a reversed net resource transfer not so much because of too much aid in the past or because the terms of aid were too hard. Rather, it was mainly because of inadequate aid or official flows and heavy reliance on private flows, particularly in the 1970s, when surging oil prices pushed real interest rates of commercial loans down to almost zero. These high-debt countries have been trying hard to meet their maturing debt obligations by generating a trade and savings surplus through contractionary economic measures.

Data¹⁷ from 18 high-debt countries show that they generated a surplus not through increased exports or savings (which is what aid is seeking or hoping to accomplish in the long-run). Instead, they accomplished it by reducing imports by an average of 9.7 percent between 1980 and 1984. The share of current account deficit to GNP declined from 3.7 percent for the period 1978-1981 to 0.1 percent in 1984 and the trade balance was transformed from a deficit of 1.5 percent to a surplus of 4.2 percent. While a surplus was generated to service the debt, GDP

47. Marcelo Selowsky and Herman G. Van der Tak, "The Debt Problem and Growth," p. 1108.

declined annually by 0.3 percent and per capita consumption by 1.8 percent. These countries,¹⁸ therefore, sacrificed growth for debt service.

How long can growth be sacrificed for debt service? Would the political will be strong enough to permit continued pursuit of policies designed to generate a surplus for debt service? Assuming that there is strong political will, would such policies be socially acceptable? Recent events in Venezuela seem to suggest a negative answer and a need to search for alternative ways of addressing the debt problem. It will be recalled that riots erupted in Venezuela sometime early this year mainly as a consequence of economic austerity measures geared toward generating a surplus for meeting debt service obligations. New commercial lending to allow more time for effective economic adjustments would be one alternative to generating a surplus now. Debt relief through debt reduction and softening of the terms for debt servicing would be another. Aid can play a role in the search for alternatives as an instrument for debt relief in lieu of or in combination with new commercial lending. Indeed, searching for new ways of dealing with the debt problem offers an opportunity and a challenge to donors to use aid for debt relief as an innovative means of aid delivery. This mode of aid delivery certainly avoids the difficulties usually encountered in traditional aid delivery schemes which we discussed earlier in some detail, particularly aid delivered through the project mechanism. At the same time, it provides much needed relief from the heavy debt service burden of a recipient country, representing a considerable drain in its own resources which would otherwise be used for development. Clearly, the ability of a heavily indebted country to absorb new aid quickly and effectively would greatly depend on the willingness of the

48. These countries are as follows: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Ivory Coast, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, Yugoslavia.

donor community to use aid for debt relief, especially for extinguishing debts with hardest terms from private sources.

Debt relief has long been recognized as a legitimate and useful form of aid delivery particularly for heavily-indebted countries. As early as 1969, the Pearson Commission recommended, among others, "that aid giving countries consider debt relief a legitimate form of aid and permit the use of new loans to refinance debt payments, in order to reduce the need for full-scale debt relief negotiations."¹⁹

Proceeds from new aid, preferably in grants, may be used directly for refinancing of payments for outstanding debts as recommended by the Pearson Commission or for retiring some with hardest terms at a discount or with different combinations and variations thereof. There are many other debt relief schemes involving the private sector, albeit somewhat more complicated, in which new aid could fit in. Whatever scheme may be chosen should be welcome by the recipient so long as it is simple enough to allow quick aid absorption and result in some form of reduction in debt and in debt service payments.

It is heartening to note, in this regard, that the policy recently enunciated by the U.S. Government, through Treasury Secretary Brady, towards finding a solution to the international debt crisis now incorporates an element of debt relief. The previous policy under the so-called (Former Secretary) Baker Plan essentially called for provision of new money to debtor countries so that they can meet maturing obligations (re-financing) and the requirements for growth. Under the Brady plan, provision of new money is retained as an element, but less emphasis is now placed thereon. Instead, the emphasis is more on debt relief through reduction of outstanding debt and debt service payments so that more domestic

49. Commission on International Development, *Partners in Development* (New York: Praeger Publishers, New York, 1969), p. 159.

resources may be used by debtor countries for growth.²⁰ The latter involves either reduction of rate of interest or lengthening of schedule of principal repayment. Debt service is, of course, reduced further as the stock of outstanding debt itself is reduced. Apart from outright debt forgiveness, outstanding debt may be reduced through debt buybacks and various swaps, i.e., discounting the value of a debt to the current market price at which it is traded and selling it back to the debtor at that discounted price for cash or converting it to equity, bonds or other debts with lower risks.

Both the International Monetary Fund and the World Bank have taken positive steps in line with the Brady plan. The former has reportedly adopted a new lending policy which is less linked to the outcome of debt relief negotiations between the debtor countries and the commercial banks.²¹

The World Bank, on the other hand, initially announced that it will spend \$10 billion in three years to help heavily indebted countries reduce their debt and debt service payments. Subsequently, IBRD and IMF reportedly worked out operational guidelines to support the Brady Plan indicating that \$11 billion from each will be available over three years in the form of guarantees or "credit enhancements." In addition, Japan also announced that it would commit \$10 billion for additional lending to highly indebted countries in parallel with IMF and IBRD lending programs for debt reduction. A total of \$32 billion, therefore, is now available for a three-year period from these three sources in support of debt reduction under the Brady Plan.²² Within the framework of the Brady Plan, Mexico successfully negotiated with its commercial creditors a new debt

50. Peter Kilborn, "New Plans on World Debt Seen," *New York Times* (February 3, 1989):D1.

51. Peter Kilborn, "Banks Urged to Broaden Debt Burden," *New York Times* (June 1, 1989):D3.

52. Edward R. Fried and Philip H. Trezise, "Third World Debt: Phase Three Begins," *The Brookings Review* (Fall 1989):27.

agreement last July combining elements of debt reduction, softening of terms of debt service and provision of new money. Agreement on the debt relief component was facilitated by the readiness of IMF, IBRD and Japan to provide financing of zero-coupon U.S. Treasury bonds to secure new 30-year bonds offered by Mexico in exchange for old debts. A month later, in August, the Philippines concluded its own negotiations whose main feature was use of new money for debt buybacks at a discount in the secondary market.²³ The successful conclusion of these two negotiations indicates good prospects that, with the cooperation of the aid community, the Brady Plan would be a feasible alternative of effectively addressing the international debt problem. Indeed, willingness of aid sources like Japan and IBRD to use aid for debt relief would be crucial for the success or failure of the Brady Plan.

Using aid for debt relief remains consistent with the theoretical justification for aid in the two-gap model. For countries that had to overcome a trade gap but did not become heavily indebted to the commercial banks through more prudent sourcing of capital inflow, it was official flows or direct foreign investment which presumably provided the stimulus for growth. These flows supplemented domestic savings and export earnings to allow the level of investment and exports required for growth. For countries that became heavily indebted to the commercial banks, it was not so much official flows which filled the savings or trade gap. Rather, it was mainly private flows in the form of commercial loans which filled the gap thereby allowing these countries to achieve respectable growth in the 1970s. As petrodollars become less abundant and interest rates increase in the 1980s, the burden of servicing the debt has now become the constraint to growth. Rather than supplementing domestic savings and export

53. *Ibid.*, p. 31.

earnings to finance investment and imports, aid for debt relief would now reduce the need to contract domestic investment and imports so that a surplus can be generated for debt service. With aid for debt relief and given more time to implement adjustment measures geared towards more efficient use of resources, especially capital, the surplus for debt service can then be generated through enhanced ability to save and to export.

Chapter IV Foreign Aid, Capital Absorption and Economic Growth in the Philippines

Growth Performance

The Philippines is one of the six countries comprising the Association of Southeast Asian Nations (ASEAN) with a population of around 60 million and growing at 2.4 percent annually. It was one of the fastest growing economies in Asia in the post-war decades until it suffered an economic downturn and then contraction in the first half of the 1980s. In the second half of the 1970s, it posted an average annual growth in real GNP and GDP of 6.2 percent (see Table IV-1). Thereafter, the economy began to slow down when GNP growth decelerated to 3.4 percent in 1981, 1.9 percent in 1982 and 1.1 percent in 1983. The economy subsequently suffered a contraction when GNP declined by 7.1 percent in 1984 and 4.1 percent in 1985. Thus, for the first half of the 80s, GNP and GDP posted a negative average annual growth of 1.0 percent and 0.4 percent, respectively. Since population was growing at 2.4 percent annually, per capita GNP started to decline in 1982. By the end of 1985, it was estimated that the economy had been set back by ten years in terms of per capita GNP.

After the change of government in February 1986, the economic situation improved. Economic recovery began when GNP and GDP posted positive growth of 1.9 percent and 1.4 percent, respectively, in 1986. The momentum was sustained as GNP growth accelerated to 5.9 percent in 1987 and 6.8 percent in 1988.

Capital Absorption and Investment Efficiency

Investment performance in the Philippines in terms of absorption and efficiency exhibited a pattern which is similar and closely linked to overall

economic performance (see Table IV-1). During the second half of the 1970s, fixed capital formation amounted to P18.8 billion annually (at 72 prices), of which P4.15 billion (22 percent) was in the public sector. This amount represented an average annual growth of 8.8 percent, a fixed investment rate of 24.6 percent, and an investment efficiency in terms of ICOR of 3.9. This rate and efficiency of investment yielded an average GDP annual growth of 6.2 percent for the same period.

TABLE IV-1					
Selected Indicators of Growth, Capital Absorption and Investment Efficiency in the Philippines					
	Annual Average				
	1975-80	1980-85	1986	1987	1988
Real GDP Growth Rate (%)	6.2	-0.4	1.4	4.7	6.4
Real GNP Growth Rate (%)	6.2	-1.0	1.9	5.9	6.8
Fixed Capital Formation (amount in billion 72 pesos)	18.8	20.05	10.1	11.6	13.7
Of Which: Government	4.15	4.2	2.2	2.3	2.3
GDP (amount in billion 72 pesos)	80.7	95.25	91.2	95.5	101.6
Real Growth of Fixed Capital Formation (%)	8.8	-11.0	-15.0	15.7	17.4
Real Growth of Public Investment (%)	18.0	-10.8	-6.7	8.4	7.8
Investment as % of GDP (at current prices):					
Total Investment Rate	29.9	24.5	12.9	15.6	17.1
Fixed Investment Rate	24.6	22.4	12.9	13.9	15.1
Public Investment Rate***	5.8	5.2	3.7	3.8	3.8
ICOR**	3.9	negative*	7.9	2.7	2.2
* 6.5 for 1978-83					
** Based on Fixed Investment at constant prices.					
*** Public Investment = Government Construction + 15 percent (Durable Equipment) as Percent of GDP.					
Source of Basic Data: Republic of the Philippines, National Statistical Coordination Board, National Income Accounts as of May 1989.					

The rate of capital formation over time and the efficiency with which incremental capital was used for that period may be considered normal and comparable to other countries which posted the same growth performance. The

average annual growth of capital formation for all middle-income economies for 1965-1980 was 8.9 percent. Investment rate computed at 29.9 percent may be considered on the high side compared to the weighted average for all middle-income economies of 21 percent in 1965 and 23 percent in 1986.⁵⁴

With respect to investment efficiency, seven middle-income economies which posted an average annual growth of GDP of 6.6 percent for 1973-80 had an average ICOR of 3.7.⁵⁵ Malaysia, which posted 7.5 percent GDP growth, had an ICOR of 3.3 while Morocco, which recorded a lower growth at 5.9 percent, had a higher ICOR of 5.0. The performance of the Philippines at 6.2 percent GDP growth with an ICOR of 3.9 is within the range of economic growth and investment efficiency performance of the two other aforementioned countries.

The next 5-year period (1980-85) was an entirely different story. Fixed capital formation declined significantly in 1984 and 1985 at -32.5 percent and -24.2 percent, respectively, as the country suffered from economic contraction and capital flight. Even though fixed investment still managed a positive growth in 1981 at 3.5 percent, the average for the five year period was -11 percent. This momentum was carried into 1986 as fixed investment declined further by -15 percent. While most other middle income economies were experiencing a contraction in investment as a consequence mainly of the world-wide recession during this period, it is noteworthy that, among ASEAN countries, only the Philippines had such an experience. For the period 1980-86, the Philippines recorded a negative average annual growth of -17 percent in gross domestic investment compared to the weighted average for all middle-income economies

54. World Bank, *World Development Report* (1988), p. 230.

55. World Bank, "Toward Sustaining the Economic Recovery. Country Economic Memorandum: Philippines," Report No. 7438-PHI (January 1989), p. 42.

of -2.3 percent. Indonesia, Thailand, Malaysia and Singapore even posted a positive growth of 3.7 percent, 0.8 percent, 0.8 percent and 3.3 percent, respectively.⁵⁶

As the amount of investment declined significantly, investment rate correspondingly declined from 29.9 percent in the late 1970s to 24.5 percent for the period 1980-85 and further to 12.9 percent in 1986. And so did public investment rate (public investment share to GDP) from 5.8 percent to 5.2 percent and further to 3.7 percent. In 1986, the investment rate for the four other ASEAN countries was 28 percent on the average.⁵⁷

As real GDP actually declined from 1980 to 1985, ICOR was negative! However, when computed for the five-year period (1978-1983) before GDP contracted, it was 6.5 indicating a marked deterioration in resource use efficiency compared to 3.9 for 1975-80. As GDP posted only a small positive growth in 1986, computed ICOR for that year increased further to 7.9 percent.

Based on these numbers, one could say that the limit to capital absorption was not only reached but even exceeded in the first half of the 1980s as the average rate of return on investment fell much lower than what might be considered as an acceptable rate. In fact, the computed average return did not only approach zero; it was negative for two years. As a consequence of investments with low or no returns during this period, a significant amount of the capital stock became unused. Officially referred to as "nonperforming assets" this portion of the capital stock was valued at P108 billion (\$5.1 billion) as of June 30, 1986.⁵⁸

56. World Bank, *World Development Report* (1988), pp. 228-229.

57. World Bank, *World Development Report* (1988), pp. 230-231.

58. World Bank, "Toward Sustaining the Economic Recovery. County Economic Memorandum: Philippines," p. 32.

As the economy started to recover in 1986 and the recovery gained more speed in 1987 and 1988, indicators of capital absorption and investment efficiency also improved. After declining for four consecutive years since 1983, fixed capital formation turned around and grew by 15.7 percent in 1987 and 17.4 percent in 1988. While investment rate consequently improved from 12.9 percent in 1986 to 15.6 percent in 1987 and 17.1 percent in 1988, it was still far below the rates attained before the economic crisis. Despite low rates of investment, respectable growth in GNP was attained as previously unused capacity was tapped. This phenomenon is reflected by the extremely low ICOR of 2.7 in 1987 and 2.2 in 1988.

Public investment also posted a positive growth of 8.4 percent in 1987 and 7.8 percent in 1988 after four years of continuous decline. This growth, however, failed to improve significantly the public investment rate which fell to only 3.7 percent in 1986 from 5.8 percent in the 1970s. In 1987, public investment rate was still 3.8 percent which fell short of the target of over 5 percent. In 1988, actual public investment rate of 3.8 percent was also short of a less optimistic target of 4.6 percent, suggesting that capital absorption posed more difficulty in the public sector relative to the private sector for the past two years.

Financing of Investment

As a market economy, private investment accounts for about three-fourths of total domestic investment. For the period 1983-1987, the private sector generated enough savings to finance its own investment and part of public investment. On the other hand, the public sector, including local governments and government corporations, had negative savings and used part of private savings and foreign savings (current account deficit) to finance not only its investment but also part of its current expenditure. Except for 1986 when private savings was more than

enough to cover private investment and the public sector deficit thereby yielding a surplus, foreign savings has always supplemented domestic savings in financing domestic investment as shown in Table IV-2.

	1983	1984	1985	1986	1987	1988 (Projected)
Public						
Savings	-2.8	-3.8	-2.2	-2.2	0.4	-1.7
Investment	6.2	4.4	3.7	3.2	3.6	4.0
S-I	-9.0	-8.2	-5.9	-5.4	-3.2	-5.7
Private						
Savings	19.9	18.8	17.2	18.2	12.0	16.1
Investment	19.0	14.6	11.4	9.8	10.4	12.0
S-I	0.9	4.2	5.8	8.4	1.6	4.1
Total Resource Gap	-8.1	-4.0	-0.1	3.0	-1.6	-1.6

Source: World Bank, "Toward Sustaining the Economic Recovery. Country Economic Memorandum: Philippines," Report No. 7438-PHI

While a surplus was recorded in 1986, it should be noted that it was not so much due to higher savings as lower investment which, as pointed out earlier, declined by 15 percent that year in absolute amount (see Table IV-1). The investment rate, which had been declining in the early 1980s from 30 percent in the late 1970s and was only 15.1 percent in 1985, declined further to 12.9 percent in 1986 before it finally turned around in 1987 at 15.6 percent.

External Transactions

The pattern of investment financing shown in Table IV-2 which relied significantly on foreign savings (except for 1986) is reflected in the country's external transactions. The resource gap (S-I), which declined to 4.0 percent and 0.1 percent of GNP in 1984 and 1985, respectively, from 8.1 percent of GNP in 1983, followed closely the behavior of the foreign exchange gap (X-M). From a huge amount of \$3.2 billion in 1983 (which by definition should also be

representing 8.1 percent of GNP) the X-M gap declined to \$1.5 billion in 1984 and to \$0.4 billion in 1985. The foreign exchange gap was turned into a surplus of \$0.6 billion in 1986 before it became a deficit again in 1987 and 1988 (see Tables IV-3 and IV-4).

	1975	1976	1977	1978	1979	1980	1981
Merchandise Trade	-1165	-1060	-764	-1307	-1540	-1939	-2224
Exports	2294	2574	3151	3425	4602	5788	5722
Imports	3459	3634	3915	4732	6142	7727	7946
Services	-45	-259	-248	-107	-311	-393	-309
Receipts	907	871	1085	1484	1655	2222	2896
Payments of which:	952	1130	1333	1591	1966	2621	3205
Interest	234	259	236	440	626	975	1374
X-M	-1210	-1308	-1012	-1414	-1851	-2338	-2333
Net Transfers	318	269	260	312	355	434	472
Current Account Balance	-892	-1050	-752	-1102	-1496	-1904	-2061
Net Direct Investment	125	144	216	100	20	-102	175
Net MLT Inflow	357	1040	662	891	1151	1032	1332
Inflow	677	1407	1242	1850	2110	1579	2076
Outflow	320	367	580	959	959	547	740
Net ST Inflow	70	-332	-172	-90	95	324	-28
Capital Account (Non-Monetary) Balance	552	852	706	901	676	1254	1479
Errors and Omissions,, Monetization of Gold and Other Adjustments	-181	37	210	147	151	269	22
Overall BOP	-521	-161	164	-54	-669	-381	-560
Source: World Bank, "Toward Sustaining the Economic Recovery. Country Economic Memorandum: Philippines," Report No. 7438-PHI							

X-M deficit reached its peak in 1982 when the economy was in a downturn and just before it contracted. The huge deficit was brought about mainly by a 12 percent decline in merchandise exports from the level a year ago and a surge in interest payments which more than doubled from \$975 million in 1980 to almost \$2 billion by 1982.

	1982	1983	1984	1985	1986	1987	1988
Merchandise Trade	-2646	-2482	-679	-482	-202	-1017	-1085
Exports	5021	5005	5391	4629	4842	5720	7074
Imports	7667	7487	6070	5111	5044	6737	8159
Services	-1040	-740	-818	85	757	-76	-77
Receipts	2983	3127	2626	3288	3791	3497	3606
Payments	4023	3867	3444	3203	3034	3573	3683
of which: Interest	1990	1985	2257	2208	2046	2226	2041
X-M	-3686	-3222	-1497	-397	555	-1093	-1162
Net Transfers	486	472	381	379	441	554	789
Current Account Balance	-3200	-2750	-1116	-18	936	-539	-373
Net Direct Investment	17	112	17	17	140	205	986
Net MLT Inflow	1548	1347	412	890	815	242	-329
Inflow	2533	2336	1413	2344	2545	2437	2372
Re-scheduling				1313	1110	1456	
Outflow	985	989	1001	1454	1730	2195	2701
Net ST Inflow	100	-611	519	-1487	-814	52	-205
Capital Account (Non-Monetary) Balance	1665	848	914	-580	141	499	452
Errors and Omissions, Monetization of Gold and Other Adjustments	-94	-204	330	770	105	304	437
Overall BOP	-1629	-2106	128	172	1242	264	516
Source: World Bank, "Toward Sustaining the Economic Recovery. Country Economic Memorandum: Philippines," Report No. 7438-PHI for 82-87; Central Bank for 1988.							

On the other hand, a surplus was generated in 1986 for the first time since the 1970s mainly because merchandise exports, which had been generally declining since the economic downturn began in 1980, finally made a turnaround and posted an increase of 4.6 percent over 1985 level, equivalent to what it was in 1979. As merchandise exports made a recovery, imports continued its decline which had also been going on since the recession began in 1981. It was only in the following year (1987) when imports managed to turn around as the economic recovery process accelerated. This is consistent with the behavior of investment which continued to decline in 1986 and managed to turn around only in 1987.

On the invisible portion, rental for military bases by the U.S. government paid through the Economic Support Fund, which increased by \$300 million after the change in government, and reduction in interest payments by \$162 million as a result of the renegotiation of the terms of outstanding debt also contributed to the generation of the X-M surplus.

The X-M deficits were somehow mitigated by consistently positive net transfers, averaging about \$450 million annually in 1982-1987, of which \$200 million or almost 50 percent was official transfers or ODA grants. Thus, the current account deficit in 1982 came down to \$3.2 billion, lower by \$486 million in net transfer than the X-M deficit of \$3.7 billion. On the other hand, the current account surplus in 1986 almost reached \$1 billion even though the X-M surplus was only \$555 million because of net transfers of \$441 million.

Let us now turn to the financing of the current account deficit. Like many of the now-heavily-indebted-countries, the Philippines started importing capital heavily when petrodollars became abundant in the late 1970s to finance its deficit. In 1975, 40 percent of the deficit was financed by net inflow of medium- and long-term loans (MLT), 20 percent by net inflow of short-term (ST) capital and direct investment, and the remaining 40 percent by use of existing international reserves. Total MLT inflow, however, was only \$677 million, representing 20 percent of merchandise imports. In 1976, MLT inflow more than doubled at \$1.4 billion, representing almost 40 percent of merchandise imports. Net MLT inflow was \$1.04 billion, financing almost the entire deficit of \$1.05 billion. Thereafter and until 1979, about 80 percent of the deficit was financed by net MLT inflow, with net direct investment playing an insignificant role. By 1978, MLT outflow began to exact its toll in the capital account when it reached almost \$1 billion compared to only \$.5 billion in 1977. Interest payments also increased significantly that year by 86 percent. Together, they brought up debt

service to \$1.4 billion, representing 28 percent of export receipts. In 1975, debt service amounted to \$554 million, representing only 17 percent of export receipts.⁵⁹

From 1980 to 1984 when the deficit was at its highest ranging from \$1.1 to \$3.2 billion, net inflow from MLT loans was financing about 50 percent of the deficit. During this period, about one-third of MLT inflow was accounted for by concessional loan aid. In 1982, availment of MLT loans reached its maximum at \$2.5 billion, representing 33 percent of merchandise imports. Debt service also increased further to \$3 billion (or 37 percent of export receipts), of which \$2 billion was for interest payments. Net capital inflow from MLT loans was \$1.5 billion, financing 48 percent of the deficit of \$3.2 billion. Net direct investment was minimal as usual at \$17 million and net inflow from ST loans was \$100 million. Thus, total inflow from the capital account was only \$1.7 billion. The remainder of \$1.5 billion was therefore financed through drawdown in reserves or inflow not captured in the BOP, reflected by errors and omissions.

In 1983, net inflow from MLT loans started to decline at \$1.3 billion from the peak of \$1.5 billion the year before as new availment decreased and repayment continued to build up. This was accompanied by a net outflow of short-term loans. Thus, net inflow from the capital account again fell short of the current account deficit by around \$2 billion, implying further drawdown in reserves.

As the economy contracted in 1984-85, merchandise imports declined abruptly by 23 percent and 15 percent in 1984 and 1985, respectively, thereby

59. The maximum statutory debt service ratio is 20 percent. However, it is computed as a fraction of total foreign exchange inflow, inclusive of inflows in the capital account. See Romeo A. Reyes, *Official Development Assistance to the Philippines: A Study of Administrative Capacity and Performance* (NEDA, 1984), p. 194.

reducing the deficit to \$1.1 billion in 1984 and to a minimal amount of \$18 million in 1985. New availments of MLT loans correspondingly declined by 65 percent from \$2.3 billion in 1983 to \$1.4 billion in 1984. As repayment of principal from past debt continued, net inflow from MLT loans dropped to \$412 million, financing only 37 percent of the deficit. Short-term credits were revived in 1984 as the panic arising from the August 1983 event subsided somewhat resulting in a net inflow of ST loans amounting to \$519 million which financed 46 percent of the deficit. However, foreign investors continued to repatriate their capital at over \$100 million annually since 1982. All told, a net inflow in the capital account of \$914 million was recorded in 1984. Including errors and omissions and monetization of gold, a positive overall BOP balance was achieved thereby allowing modest build up of international reserves.

The reserve position was further strengthened in 1985 as the current account deficit was reduced to a minimum mainly due to economic contraction. As a result of rescheduling of principal repayment falling due that year amounting to \$1.3 billion and unusually large errors and omissions of \$770 million, an overall BOP surplus was realized, notwithstanding a huge net repayment of ST credit in the amount of \$1.5 billion.

With a current account surplus of almost a billion dollar in 1986 and rescheduling of principal repayment of another billion falling due that year, a huge overall BOP surplus exceeding \$1 billion was generated in 1986, notwithstanding a net repayment of ST loans of \$814 million, further strengthening the country's external position.

In 1987, a current account deficit of about half a billion dollar was again registered. As in 1985, this was more than offset by rescheduling of principal repayment amounting to \$1.4 billion. If not for rescheduling, net inflow from

MLT loans and from the entire nonmonetary capital account would have been negative (disregarding errors and omissions) since 1985.

Mainly due to increase in net transfer from official sources, smaller current account deficit of \$373 million was registered in 1988. This was more than offset by a net inflow of almost a billion from net direct investment which for the first time since the 1970s became the most significant source of financing the current account deficit. In 1988, both MLT and ST loans registered net outflows.

As a consequence of persistent deficit in the current account and of importation of foreign capital as principal means of financing, outstanding external debt increased steadily from only \$1.6 billion in 1970 to \$17.4 billion in 1980, and \$28.6 billion in 1987 (see Table IV-5). As external debt accumulated, debt service necessarily increased from \$554 million, representing 17.3 percent of exports of goods and services, in 1975 to \$4.4 billion or around 50 percent of exports receipts in 1987. Of total debt service in 1987, \$2.2 billion, or about one-fourth of export receipts, was for interest payments. In 1975, interest payment was only \$234 million or 7.3 percent of export receipts. Thus, foreign borrowing which has been the principal source of financing the current account deficit also became a principal cause of the deficit itself. Due to heavy debt servicing, a situation of negative net resource transfer from creditors was reached way back in 1981 when interest and repayment exceeded new availment by \$42 million. Thereafter, it steadily increased and reached \$3.4 billion by 1987. Taking into account net official transfers from donors, a negative net resource transfer from both creditors and donors actually took place a year later in 1982 when net resource transfer from creditors of -\$442 million exceeded net official transfer from donors of \$164 million, thereby bringing about a negative net transfer from both sources of -\$278 million.

TABLE IV-5									
Philippines: Selected Indicators of External Transactions									
(In millions of U.S. dollars)									
	1975	1980	1981	1982	1983	1984	1985	1986	1987
Current Account Balance	-892	-1904	-2061	-3200	-2750	-1116	-18	996	-539
External Debt Outstanding	4900	17390	-	-	24816	24361	26161	28256	28600
Debt Service ⁴	554	1522	2114	2975	2974	3258	3662	3776	4421
Repayment ¹	320	547	740	985	989	1001	1454	1730	2195
Interest	234	975	1374	1990	1985	2257	2208	2046	2226
As percent of exports, of goods and services	17.3	19.0	24.5	37.2	36.6	40.6	46.2	43.8	48.0
Exports of Goods and Services	3201	8010	8618	8004	8132	8017	7917	8623	9217
Net Resource Transfer from Creditors ²	123	57	-42	-442	-638	-1845	-2631	-2341	-3440
Net Official Transfer from Donors ³	151	134	147	164	235	n.a.	207	206	197
Net Resource Transfer from Creditors and Donors	274	191	105	-278	-403	-1845	-2424	-2135	-3243
New Availment from Creditors	677	1579	2072	2533	2336	1413	1031	1435	981
¹ MLT Loans									
² New Availment from creditors less debt service before rescheduling. After rescheduling net resource transfer from creditors was reduced to \$1,352 million in 1986, \$2,102 million in 1987 and \$2,593 million in 1988. The negative net resource transfer for 1988 represents 5 percent of total net resource flow of \$50 billion from all developing countries to international creditors. See Clyde Farnsworth, "For Developing Countries, Debt Payments Outstrip Aid," <i>New York Times</i> September 18, 1989, page D1.									
³ Based on BOP figures									
⁴ Before rescheduling of maturities falling due after 1986. After re-scheduling, debt service ratio was reduced to 32.8 in 1987.									
Source: Central Bank of the Philippines.									

Foreign Aid and the Balance of Payments

As shown in the foregoing section, net official transfers in the BOP, representing grants received from official sources net of the small amount which the Philippines provided to the rest of the world (e.g., contributions to international organizations) delayed somewhat the reversal of resource flows from the country's creditors and donors. Apart from that, foreign aid figured in

many other respects in the evolution of the current account deficit and its financing, particularly in the accumulation of foreign indebtedness.

At this point, it would be useful to recall that foreign aid is provided in grants and in loans. In the case of the former, it is entered in the current account as inflow from official transfer. When it is tied fully to foreign exchange cost, it is matched by an outflow through imports of goods and services. When it is only partially tied, the outflow could be less than inflow and may help reduce the current account deficit.

Aid provided by the U.S. government under the Economic Support Fund (ESF) needs some explanation. While it is considered by the U.S. as part of its foreign assistance whose allocation and disbursement are covered by U.S. foreign aid legislation, it is viewed by the Philippine government as rental payment for the use of military bases. In fact, the amount of ESF money which the Executive Branch of the U.S. government committed itself to provide (on a best-effort basis subject to approval and appropriation by the Congress) is linked to the use of military bases in the Philippines and explicitly provided in the current Military Bases Agreement between the two governments. As such, it is entered as receipt from export of services, it being a factor income from abroad. (However, for purposes of this paper only, ESF will be considered as part of U.S. ODA to the Philippines.) Since ESF money is mostly untied (except for a minor portion for consultancy), it is an important item for reducing not only the current account deficit but more specifically the X-M deficit.

The effect of aid on the current account and on the BOP in general when aid is provided in loans is quite different. On the one hand, it is a source of financing of the current account deficit when it is availed of. On the other hand, it aggravates the current account deficit when interest is paid and reduces net capital inflow when principal is repaid.

Total aid commitment, i.e., ODA covered by loan and grant agreement for specific purposes, from 1980 until 1984 was recorded at over \$1 billion dollars annually (see Table IV-6). At the height of the economic crisis in 1985 and just before the change in government, commitment fell to \$700 million, mainly because aid previously committed could not be disbursed for lack of counterpart funds. Disbursement had a lower average at around \$800 million for the same period presumably on account of partial cancellation/deobligation of previously committed aid. The loan/grant ratio was approximately 85/15.

After the change of government, aid commitment jumped to around \$1.5 billion in 1986 and in 1987 and further to \$2.2 billion in 1988. As a gesture of international goodwill, aid commitment improved not only in quantity but also in quality as the loan/grant mix significantly improved to 50/45 in 1986. It then became 65/35 in 1987 before it reverted to the old mix of 85/15 in 1988 (see Table IV-8).

Disbursement of aid also improved significantly from \$700 million in 1985 to \$1.3 billion in 1986. It should be noted, however, that the bulk of the increase in disbursement was accounted for by grants provided by the U.S. mainly under the ESF account for budget support and by program and commodity loans which are relatively more quick-disbursing. Thereafter, disbursement levels declined slightly to \$1.2 billion in 1987 and further to \$1.1 billion in 1988 (based on data compiled by the NEDA Secretariat).

ODA flows (disbursements) in loans and grants averaged around \$650 million and \$150 million, respectively, from 1980 to 1985. ODA loans steadily became a significant proportion of total MLT inflow during that period. From only 11.2 percent in 1978, it rose to 25.7 in 1980 and 53.3 percent in 1985. On the other hand, ODA grants were relatively insignificant when viewed as a percentage of nonmerchandise export receipts at 3.4 percent in 1978, 4.2 percent

TABLE IV-6 Philippines: Foreign Aid Commitment and Disbursement (in millions of U.S. dollars)								
	1978	1980	1983	1984	1985	1986	1987	1988
ODA Commitment	1081	1244	1141	1101	705	1467	1451	2235
Loans	1017	1109	952	900	442	821	933	1874
Grants	64	135	189	201	263	646	518	361
ODA Disbursement	258	500	1146	751	701	1284	1224	1082
Loans	208	406	1002	577	550	796	911	915
Grants	50	94	144	174	151	488	313	167
ODA Loan Disbursement as percent of MLT Inflow	11.2	25.7	42.9	40.8	53.3	55.5	92.8	88.1
MLT Inflow ¹	1850	1579	2336	1413	1031	1435	981	1039
Non-Merchandise Exports	1484	2222	3127	2626	3288	3791	3495	3606
ODA Grant Disbursement as percent of Non-Merchandise Exports	3.4	4.2	4.6	6.6	4.6	12.9	9.0	4.6
X-M ²	-1414	-2338	-3222	-1497	-397	555	-1093	-1162
Total ODA Disbursement as percent of X-M	18.2	21.4	35.6	50.0	176.6	189.5	51.8	93.1

Source: NEDA Public Investment Staff, Project Monitoring Staff.

in 1980 and 4.6 percent in 1985. After the change in government, ODA loan disbursement increased considerably from \$550 million in 1985 to \$796 million in 1986, but only slightly in terms of its share to total MLT inflow from 53 percent to 55 percent. This was due mainly to almost doubling of loan commitment for the same period mainly in the form of quick disbursing program and commodity loans. Loan disbursement increased further in 1987 both in absolute amount and as a proportion of MLT inflow. Grant disbursement, however, exhibited a downward trend as USAID assistance in the form of budget support declined. In 1988, total aid disbursement declined to just over a billion as grant disbursement declined further. For the three-year period 1986-88 after the change in government, disbursement represented 70 percent of commitment.

It should be noted at this point that foreign aid flows have increasingly been relied upon in filling-in the foreign exchange gap or the X-M deficit. From only 18.2 percent of the X-M deficit in 1978 the share of foreign aid flows increased to 21.4 percent in 1980 and to 35.6 percent in 1983 when the X-M and current account deficits were almost at their peak. During the period of economic contraction in 1984-85 when MLT inflows from commercial loans declined and short-term trade credits could not be rolled-over, ODA inflows served the country in good stead in terms of filling-in the trade gap and the current account deficit. In 1984-85, ODA flows also declined like MLT inflows but not as much thereby assuming a much larger role in financing the deficit.

Origin of Foreign Aid

Foreign aid to the Philippines originates from both multilateral and bilateral sources. In the late 1970s and early 1980s, most of the aid came from multilateral sources, particularly the World Bank and the Asian Development Bank (see Table IV-7). In 1978-81, \$2.7 billion or 66 percent of total aid commitment in the

TABLE IV-7					
Philippines: Origin of Foreign Aid on Commitment Basis					
(In millions of U.S. dollars)					
	1978-1981	1982-1985	1986	1987	1988
Multilateral	2694	2237	545	397	917
IBRD	1824	1347	151	342	506
ADB	737	768	324	45	384
EEC,19	7	45	-	10	-
IFAD	21	14	-	5	-
OPEC Fund	21	20	-	-	7
UN System	71	81	25	6	9
Bilateral	1388	1905	922	1054	1319
Japan	765	1158	372	573	881
U.S.	327	571	436	378	58
FRG	81	89	21	32	39
Canada	1	4	75	30	20
Australia	29	45	18	19	16
Italy	-	3	-	-	90
France	51	1	-	-	43
Netherlands	1	5	-	-	15
Belgium	32	10	-	7	8
Denmark	16	11	-	-	-
Switzerland	-	-	-	-	40
Spain	6	1	-	10	75
U.K.	34	1	-	-	1
New Zealand	4	5	-	-	3
Others*	40	1	-	-	-
Singapore	-	-	-	5	-
TOTAL	4082	4142	1467	1451	2236

*PROC, Kuwait, Iraq, Norway, Austria, Libya.

amount of \$4.1 billion came from multilateral sources. Of the latter amount, \$1.8 billion or almost one-half came from the World Bank while \$0.7 billion or 18 percent came from the Asian Development Bank. The major bilateral sources, on the other hand, have been Japan and the United States, claiming 19 percent and 8 percent, respectively, of total aid commitment during that period. Between themselves, these four major sources of aid accounted for almost 90 percent of total aid commitment.

In the succeeding four-year period (1982-85), aid from multilateral sources declined both in absolute amount and as a proportion of total aid commitment. On the other hand, aid from bilateral sources increased by 37 percent in absolute amount and its share to total improved from 34 percent in the previous period to 46 percent mainly due to substantial increases in loans and grants from Japan and in grants from the U.S. With respect to the latter, the increase was due mainly to the renegotiation of the Military Bases Agreement which provided for a transfer of \$250 million in ESF money from 1981 to 1985. In the case of Japan, the increase resulted both from the intensification of OECF lending and JICA grant-aid programs. The four major sources increased their share to total aid commitment further to 93 percent in 1982-85 with Japan increasing its share to total from 18.7 percent in 1978-81 to 28 percent while IBRD's declined from 45 percent to 32 percent. For the same period, the loan/grant mix improved from 90/10 to 80/20 in favor of grant (see Table IV-8).

The change in government further changed the aid composition both in origin and in concessionality. In 1986, the share of bilateral sources increased further to 63 percent, with the U.S. as the leading aid donor accounting for almost one third of total aid commitment. Apart from providing additional grant of \$300 million in quick-disbursing ESF money, the U.S. also converted almost \$100 million in previously committed but undisbursed loans into grants under the

TABLE IV-8
Philippines: Summary of Foreign Aid Commitment
(In millions of U.S. dollars)

	1978-81		1982-85		1986		1987		1988	
	Amount	% Dist.								
Multilateral	2694	66.0	2237	54.0	545	37.1	397	27.4	917	41.0
Loan	2599		2143		473		390		892	
Grant	95		94		72		7		25	
Bilateral	1383	34.0	1905	46.0	922	62.9	1054	72.6	1319	59.0
Loan	1049		1151		348		543		983	
Grant	339		754		574		511		336	
TOTAL	4082	100.0	4142	100.0	1467	100.0	1451	100.0	2236	100.00
Loan	3648	89.4	3294	79.5	821	56.0	933	64.3	1875	83.9
Multilateral	2599		2143		473		390		892	
Bilateral	1049		1151		348		543		983	
Grant	434	10.6	848	20.5	646	44.0	518	35.7	361	16.7
Multilateral	95		94		72		7		25	
Bilateral	339		754		574		511		336	
TOTAL	4082	100.0	4142	100.0	1467	100.0	1451	100.0	2236	100.0

Source: NEDA, Public Investment Staff.

development assistance account. Thus, the loan-grant mix in 1986 improved further substantially to almost 55/45 in favor of grant.

Unlike the United States, Japan could not immediately translate its support to the new government in terms of new commitment of aid in 1986 for two reasons. The first had something to do with alleged irregularities in aid use under the past regime. While decision on country allocation of Japanese aid is largely in the hands of the Japanese bureaucracy, the reaction of the Japanese Diet to conduct an investigation somehow delayed action. The second was the withdrawal of several projects for which loan processing under the 13th Yen Credit Package pledged in 1985 had already commenced prior to the change in government. As a consequence, the 13th Yen Package had to be reprogrammed and could only be committed in late 1986 and the 14th Yen Package could only be pledged in 1987.

Canada emerged as a significant source of aid in 1986 among bilateral sources (see Table IV-10). Before then, only the Federal Republic of Germany and Australia were providing fairly significant amount of aid on a sustained basis. On the multilateral side, the European Economic Community (EEC) also emerged with a fairly significant aid commitment in grants. The year 1986 also saw a further reduction of the role of the World Bank as source of aid when it committed only \$151 million or 10 percent of the total, compared to almost 50 percent in 1978-81 (see Table IV-9). Part of the reason for this is that IBRD money is relatively more costly (between 7 percent and 8 percent) compared to bilateral loans (between 0 to 3.5 percent) which have become relatively more abundant although the former carried with it the benefit of international competitive procurement. It should be recalled, in this regard, that real aid depends not only on the grant element but also on the extent of tying which is typically more prevalent among bilateral sources. Nonetheless, several projects which were under processing for IBRD funding (e.g., subject of appraisal

TABLE IV-9
Philippines: Origin of Foreign Aid In Loans on Commitment Basis
(In millions of U.S. dollars)

	1978-1981	1982-1985	1986	1987	1988
Multilateral	2599	2143	473	390	892
IBRD	1824	1347	151	342	505
ADB	736	764	322	43	380
IFAD	18	12	-	5	-
OPEC Fund	21	20	-	-	7
Bilateral	1049	1151	348	543	983
Japan/OECF	654	942	305	514	708
USAID	167	132	32	-	30
German KfW	58	54	11	19	28
Belgium	32	10	-	-	-
Denmark	16	11	-	-	-
Italy	-	-	-	-	60
France	50	-	-	-	42
Switzerland	-	-	-	-	40
Spain	6	-	-	10	75
U.K.	32	-	-	-	-
Netherlands	-	1	-	-	-
Others*	34	1	-	-	-
TOTAL	3648	3294	821	933	1875
*PROC, Kuwait, Iraq.					
Source: NEDA, Public Investment Staff.					

TABLE IV-10					
Philippines: Origin of Foreign Aid In Grants on Commitment Basis					
(In millions of U.S. dollars)					
	1978-1981	1982-1985	1986	1987	1988
Multilateral	95	94	72	7	25
UN System	71	81	25	6	9
EEC	19	7	45	-	10
ADB	1	4	2	1	4
Others*	4	2	-	-	2
Bilateral	339	754	574	511	336
Japan	111	216	67	59	173
U.S.	160	439	404	378	58
Australia	29	45	18	19	16
New Zealand	4	5	-	-	3
FRG	23	35	10	13	11
Canada	1	4	75	30	20
Italy	-	3	-	-	30
France	1	1	-	-	1
U.K.	2	1	-	-	1
Netherlands	1	4	-	-	15
Belgium	-	-	-	7	8
Singapore	1	-	-	5	-
Spain	-	1	-	-	-
Others**	6	-	-	-	-
TOTAL	434	848	646	518	361
*IFAD and World Bank					
**Norway, Austria, Libya					

missions) were either fully or partially withdrawn from the IBRD pipeline and eventually funded by other sources providing grants and loans with more concessional terms. Before they were withdrawn, however, attempts were made unsuccessfully by the Philippine government to secure funding from the International Development Association (IDA), an IBRD affiliate which provides loan at zero interest.

ADB which is located in Manila initially managed to retain a respectable share of aid to the Philippines in the face of increased presence and rather aggressive stance of bilateral sources since 1986 through its concessional window, the Asian Development Fund (ADF), which also provides loan at zero interest and through its technical assistance program which allows grant assistance in preparation of projects for subsequent Bank funding. Within a month or two after the change of government in 1986, it pledged a loan of \$100 million, of which one half would be from ADF, to finance the local currency cost of on-going foreign-assisted projects which had been stalled due to lack of local budgetary resources.

With the U.S. and ADB taking the lead, the four traditional sources accounted for 87 percent of total aid commitment in 1986, slightly lower than 90 percent posted in the late 1970s and 93 percent in the early 1980s. The next three major sources—Canada, FRG and Australia—had combined share of 8 percent. Together with the four major sources, they accounted for 95 percent of total aid in 1986.

Total aid commitment in 1987 slightly declined from the level a year ago as the multilaterals lost further steam. While IBRD was able to recover from an extremely low level in 1986 through a quick-disbursing policy-based loan of \$300 million, ADB managed to commit only one loan of \$44 million for a port project plus another million in grants for technical assistance. Furthermore, EEC

which committed \$45 million in grants in 1986 was unable to commit anything in 1987. Thus, the share of multilaterals declined further to 27 percent, compared to 66 percent in 1978-81.

The bilaterals registered better performance in 1987, increasing their commitment to slightly over \$1 billion from \$922 million the year before (see Table IV-8). While the U.S. was unable to sustain its aid commitment in 1986, Japan increased its commitment by 54 percent. Two bilateral sources—Belgium and Spain—which had been inactive for sometime revived their aid-giving in 1987 although their combined commitment of \$17 million remained insignificant at 1 percent. Singapore, a member of ASEAN, also became a donor of aid to the Philippines that year with a commitment of \$5.0 million. The four traditional sources registered a share of 92 percent, almost recovering its share of 93 percent in 1978-81. The loan/grant mix was recorded at 65/35 in 1987, a deterioration against grants from 55/45 in 1986 mainly due to increase in OECF and IBRD lending and to decline in grants from U.S. and Canada.

Total aid committed in 1988 increased by 50 percent to \$2.2 billion as both ADB and IBRD restored their lending commitment to the high levels achieved in the late 1970s and early 1980s, as Japan continued to increase its annual aid commitment in line with its capital recycling program, and as additional new sources, i.e., Italy, France, Netherlands and Switzerland came into the picture with significant levels of commitment. The U.S., however, which led the "big four" in 1986, committed only \$88 million, one-fourth of what it did the year before. (It would be appropriate at this point to note that what was available for commitment from the U.S. was much more at \$262 million. We shall discuss this matter in another section on aid absorption performance.) Consequently, the share of the "big four" dropped to 83 percent. The four new sources mentioned earlier had a combined share of 8 percent, with Italy making the biggest commitment at

\$90 million. Meanwhile, the loan/grant mix was recorded at 85/15, better than 90/10 in 1978-81 but worse than 80/20 in 1982-85.

Foreign Aid Absorption: Recent Performance

Recall that, in previous sections, the magnitude of annual aid commitment and disbursement was indicated to be around \$1 billion and slightly less than \$800 million on the average, respectively for the period 1980 to 1985, yielding a disbursement/commitment ratio of around 0.75. Recall further that after the change in government, commitment jumped to \$1.5 billion in 1986, was maintained at that level in 1987 and increased further to \$2.2 billion in 1988. Disbursement levels, on the other hand, had not kept pace with commitment. After reaching a peak of \$1.3 billion in 1986, it declined to \$1.2 billion in 1987 and further to \$1.1 billion in 1988. Thus, for the recent three-year period, the disbursement/commitment ratio had declined somewhat to 0.70 from 0.75 for the period 1980-1985. This reduction in aid absorptive capacity in terms of disbursement as a proportion of commitment happened despite the fact that a substantial proportion of newly committed aid was in the form of quick-disbursing nonproject type of assistance, e.g., \$300 million and \$150 million in ESF grant for budget support from the U.S. in 1986 and 1987, policy-based Economic Recovery Loan of \$300 million from IBRD in 1987, commodity loans from Japan of at least \$100 million each in 1987 and 1988.

Even though the commitment level was relatively high at \$1.5 to \$2.2 billion annually in 1986-1988, it would be useful to look at it in light of what was pledged by donors and creditors to be available for commitment for the same period (see Table IV-7). These pledges of aid are usually documented in the form of exchange of diplomatic notes and/or Records of Discussion between responsible officials of the Philippine Government and of a particular donor.

They are not yet commitments or obligations in the sense that the loan or grant agreement specifying the purpose for which the aid will be used, its terms and conditions, etc. still have to be negotiated and mutually agreed upon. To take a concrete example, Italy pledged an amount of \$270 million in September 1987 when a high level mission visited the Philippines. The Protocol of Understanding between the Italian mission and its counterpart from the Philippine government provides that the amount pledged is available for commitment to specific projects through appropriate loan or grant agreements from 1988 to 1990. Of that amount, only \$30 million in grants had been committed to specific projects through subsequent project agreements as of end of 1988. More than a year after the pledge was made, none of the projects had commenced implementation and, as a consequence, no disbursement had been made (see Table IV-9). Unless good progress is made in satisfying conditions precedent to disbursement, it is possible that no disbursement would be made even in 1989 which might jeopardize further pledges of assistance from Italy.

Let us examine the aid absorption performance of the Philippines in terms of:

- (a) commitment as a proportion of what was pledged which is an indicator of its ability to program available aid for specific uses acceptable to donors/creditors;
- (b) disbursement as a proportion of commitment which serves as an indicator of its ability to actually absorb aid which have been programmed for specific uses;
- and (c) disbursement as a proportion of what was scheduled to be disbursed as agreed upon with donors/creditors as an indicator of its ability to absorb aid in accordance with its own schedule or target.

We shall do these first in the aggregate and then by source of aid with a view towards objectively and constructively identifying factors/reasons which had or might have contributed to the difficulty or delay in aid commitment and/or disbursement. Without attempting to find fault or put blame on any of the

institutions or actors involved in aid generation, allocation, programming, disbursement, monitoring and control, we shall then suggest measures towards the end of this paper which are deemed appropriate and feasible only in the interest of enhancing the country's aid absorptive capacity and performance.

For the three-year period since the change of government in 1986 up to December 31, 1988, traditional and new sources of aid have pledged around \$7 billion, starting with over a billion in 1986 and slightly less than \$3 billion in 1987 and in 1988 (see Table IV-11). Of this amount, \$3.8 billion or 54 percent had been committed or programmed for specific uses/purposes in terms of loan/grant agreement at the end of 1988, of which \$768 million had been disbursed thereby yielding a disbursements/commitment ratio of 0.20. This record of absorption of newly pledged aid in terms of disbursement/commitment ratio does not compare well with the overall disbursement/commitment ratio for the same period (1986-88) of 0.70 which was cited earlier and with 0.75 recorded in 1980-85.

Of the amount of \$1.3 billion pledged in 1986, 47 percent was committed that same year, 84 percent by the second year (1987) and 86 percent by the third year (1988). Of the amount of \$2.9 billion pledged subsequently in 1987, only 29 percent was committed that same year and 61 percent by the second year. In 1988, a slight improvement in "first year commitment" ratio was registered at 33 percent, which is slightly higher than 29 percent in 1987 but still much lower than 47 percent in 1986. These numbers suggest that, compared to 1986, the ability of the aid administrative system to immediately commit or program newly pledged aid for specific purposes was generally lower in 1987 and 1988, although there was some improvement between 1987 and 1988.

While the improvement in "first year commitment" between 1987 and 1988 was not significant both in absolute amount and as a proportion of total amount

TABLE IV-II				
Philippines: Aid Absorption Performance, 1986-1988¹				
(In millions of U.S. dollars)				
	1986	1987	1988	TOTAL
Aid Pledged	1279.77	2911.98	2827.02	7020.77
Committed	743.07	1103.20	1887.89	3014.16
of 1986 Pledges	743.07	336.60	23.59	1103.26
of 1987 Pledges		766.60	725.62	1532.22
of 1988 Pledges			938.63	938.63
% of Commitment to Pledges	58.06	37.88	66.78	54.33
Cumulative Progress of Commitment (in %)				
of 1986 Pledges	47.04	84.36	86.21	
of 1987 Pledges	-	29.07	60.86	
of 1988 Pledges	-	-	35.18	
Disbursement	242.50	357.40	168.34	768.24
of 1986 Commitment	242.50	82.30	11.17	335.97
of 1987 Commitment	-	275.10	97.60	372.70
of 1988 Commitment	-	-	59.57	59.57
% of Disbursement to Commitment	32.63	32.40	8.92	20.14
Cumulative Progress of Disbursement (in %)				
of 1986 Commitment	32.63	43.71	45.21	
of 1987 Commitment	-	24.94	33.73	
of 1988 Commitment	-	-	3.15	
¹ Based on Data Available as of 31 October 1988.				
Source: NEDA, Public Investment Staff.				

pledged, it should be noted that total commitment in 1988 (including those from pledges in 1986 and 1987) was significantly higher than in 1987 on both counts, \$784 million in absolute amount and 29 percentage points as a proportion of amount pledged. This improvement was accounted for mainly by considerable acceleration of processing of investment projects proposed for concessional loan financing which led to signing of 29 loan agreements valued at \$1.5 billion from January to September 1988 compared to only five projects valued at \$0.67 billion for the corresponding period a year ago.

Based on the foregoing and on other indicators of intermediate activities and events in 1987 and 1988 that would lead to eventual commitment of aid, better performance might be registered in 1989 both in terms of immediate or "first year" commitment of pledges to be made that year and total commitment, i.e., inclusive of those made from pledges prior to 1989. Looking at project proposals which had gone through the aid administrative system and endorsed to various aid sources, it will be noted that, for January to September 1988, there were 346 proposals as against 87 for the entire year of 1987. In terms of projects approved by the Investment Coordination Committee (ICC), a cabinet-level collegial body empowered to approve all major projects proposed for foreign funding prior to loan negotiation, a significant improvement was also recorded in January to September 1988 at 27 projects valued at \$1.9 billion compared to only 16 for the corresponding period in 1987 valued at \$1.3 billion. If the donor community will positively respond to these projects which the aid administrative system of the recipient country has processed, aid commitment in 1989 could exceed the highest level of \$2.2 billion attained so far in 1988.

Translating aid pledges into commitments is one thing. Translating them into disbursements so that aid is actually absorbed is another.

Let us turn to disbursements. Of the amount of newly pledged aid of \$743 million committed in 1986, 33 percent was disbursed that same year, 44 by the second year and 45 percent by the third year. Looking at the progress of disbursement of the 1987 commitment of \$1.1 billion, we find that only 25 percent was disbursed that same year and 34 percent by the second year. With regard to 1988 commitment of \$1.8 billion, only 3 percent was disbursed that year. Thus, both "first year" and total disbursement as a proportion of commitment had declined from 1986 to 1987 and then to 1988.

Again, based on these numbers, one could sense a reduction in the ability of the system to disburse aid which had been committed/programmed from new pledges.

Comparing actual disbursements with those scheduled for the same period yields a more positive picture from 1986 to 1987 but not thereafter (see Table IV-12). After posting 100 percent disbursement performance (actual as percent of schedule) in 1986 and an extraordinary one in 1987 when actual performance even exceeded target by almost 20 percent, performance in 1988 fell short of target by 50 percent. For the entire three-year period, overall performance in terms of actual as a proportion of scheduled disbursement was registered at 87.5 percent.

	1986	1987	1988	TOTAL
Scheduled Disbursement from Commitment of New Pledges	242.70	300.86	334.03	877.59
Actual Disbursement	242.50	357.40	168.34	768.24
Actual Disbursement as percent of Scheduled	99.92	118.79	50.40	87.54

Source: NEDA, Public Investment Staff.

Comparing actual disbursement with what was scheduled or targeted to be disbursed for the same period may be a more meaningful measure of aid

absorption performance in terms of timeliness and in terms of the ability of the recipient country to absorb what it has targeted for itself. The reason is that any amount of aid committed for a particular purpose, especially if it is for a specific project, cannot normally be disbursed instantly or through a single procurement event. Unless aid is simply for one shipment of food grains or one item of a huge equipment or one big contract for consulting services, disbursement will normally take place over a number of years (five on the average in the case of project aid) and through a series of procurement actions. Thus, comparing actual disbursement with scheduled disbursement rather than with commitment for a specific period would be more meaningful on condition that original schedule or target is not subsequently revised ostensibly for so many other reasons but in reality to make it conform with actual performance. Furthermore, actual performance in aid disbursement may appear extraordinarily impressive only because of extremely conservative target setting which is elementary in development planning. Anyone who wishes to make an assessment of a country's ability to absorb aid in the future will have to look beyond actual aid absorption in the past in relation to schedule. Necessarily, one would need to examine the amount of aid absorbed in the past in absolute amount and as a proportion of what was programmed, pledged and needed under a given set of circumstances to determine what can reasonably be expected to be absorbed in the future given the need and another set of circumstances.

Aid absorption in terms of cumulative disbursement of concessional loans committed to foreign-assisted projects as compared to target or schedule registered a most encouraging performance. It would be useful to recall at this juncture that aid in the form of concessional loans is provided mainly for financing of investment projects.

As shown in Table IV-13, actual cumulative availment of ODA loans as a percentage of target (also on a cumulative basis) improved steadily from 71 percent as of end of December 1987 to 77 percent as of end of September 1988. It should be noted, however, that these numbers include disbursement from newly committed and pledged loans from 1986 to 1988 as well as those committed but still undrawn prior to that period. Further, they are based on revised schedules of loan disbursement.

TABLE IV-13				
Philippines: Loan Absorption Performance of Foreign-Assisted Projects				
(In cumulative millions of U.S. dollars)				
	As of			
	Dec. 1987	March 1988	June 1988	Sept. 1988
Loan Commitment				
Scheduled Availment	3050	3200	3260	3257
Actual Availment	2164	2326	2389	2506
Backlog in Availment	886	874	871	751
Actual Availment as Percent of Scheduled Availment	71.0	72.7	73.3	76.9
Source: NEDA, Project Monitoring Staff.				

Chapter V

Translating Pledges of Aid into Commitments and Disbursements

The numbers which we looked at in the preceding section revealed that new pledges of aid had more than doubled from a level of \$1.3 billion in 1986 to almost \$3 billion in 1987 and in 1988. This is an indication that international goodwill occasioned by the change in government in 1986 and manifested in terms of aid pledges was enhanced in 1987 and maintained in 1988. To reap maximum benefits from this expression of goodwill, the country should lose no time in translating aid pledges into commitments to allow actual disbursement or absorption of aid. The numbers also suggested that immediate translation of pledges into commitments had proceeded at a slower pace in 1987 and in 1988 than in 1986 in relative terms. Overall translation of pledges into commitments, however, improved in 1988 over 1987 and there were good prospects for further improvement in 1989.

In this chapter, we shall examine the process of translating pledges into commitments and disbursements with a view towards identifying later on, when we look at specific aid sources, at which points in the process difficulties were encountered, how they emerged, and how they may be resolved.

Translating Pledges into Commitments

Indications of the amount of aid available for programming are initially manifested during "country program" missions from both multilateral and bilateral sources. In many instances, agreements and understanding reached, including the amount and, in some cases, the terms of assistance are documented through Record of Discussions, Protocol of Understanding or Agreed Minutes duly signed by both parties. This kind of documentation of aid pledges is done in

the case of Federal Republic of Germany, Italy, Australia, Denmark, France, Switzerland, Spain and Japan with respect to the Grant-Aid and Technical Cooperation Programme. Pledges of aid are documented more formally through diplomatic notes such as in the case of Japan with respect to financial cooperation (loan) program. Some donor countries, e.g., Federal Republic of Germany, which had earlier manifested their pledges in writing outside of diplomatic channel subsequently make their pledges also through diplomatic notes. In some other instances, the amount of aid available for programming is not formally documented in the sense that it is signed by both parties, e.g., United States, IBRD and ADB. Nonetheless, it is reflected in internal documentation of their assistance programs.

The amount of aid pledged may be available for programming for different durations. Many pledges are supposedly for obligation or commitment within one year inasmuch as pledges are made every year. Some donors are more strict than others. In the case of Australia and Netherlands, for instance, aid pledged should not only be committed within the year; it should also be disbursed; otherwise, it becomes unavailable. On the other hand, FRG which makes pledges every year allows commitment or actual signing of loan agreement a year or two later. In addition, it allows re-programming of previously committed aid. Others make their pledges on a multi-year basis, e.g.; Italy for three years, Canada for five years, which means that commitment is in fact intended to be made within a duration of more than a year.

Commitment or "obligation" of aid is made upon signing of a loan or grant agreement which specifies the amount and terms of aid, the purposes for which it will be used, the responsibilities of both parties and many other provisions relating to the use of aid and its repayment (in the case of loans).

We shall refer to the process of translating aid pledges into commitment as *programming* which entails determination of whether aid offered or indicated to be available by a donor/creditor will be availed of and, if so, how, when and for what purpose which is acceptable to the donor/creditor.

Let us begin by identifying responsibility and authority for aid programming as defined herein. Under Executive Order No. 230 issued by the President prior to convening of Congress when she had legislative powers, the National Economic and Development Authority (NEDA)

"shall be responsible for...programming of official development assistance in the form of grants and concessional loans from foreign governments and multilateral agencies and organizations...."⁶⁰

The NEDA is a planning agency "composed of two separate and distinct entities: the Board and the Secretariat."⁶¹ The Board is chaired by the President and its members are composed of about a dozen cabinet secretaries, including the Secretary of Finance and the Secretary of Economic Planning who is also the Director-General of the Secretariat. The Executive Order further provided that "the powers and functions of the Authority reside in the NEDA Board."⁶²

Based on the foregoing provisions of law, it is clear that both the power and function or, put another way, the authority and responsibility for aid programming reside or belong to the NEDA Board, a collegial body, of which the President is the Chairman. Thus, strictly speaking, all decisions relating to the programming of aid must be a collegial decision of the Board unless the power to make those decisions are specifically delegated to another group or a single official. Prior to the creation of the Task Force and, later on, the Coordinating

60. E.O. No. 230, *Reorganizing the National Economic and Development Authority*, Section 5, 22 July 1987.

61. *Ibid.*, Section 3.

62. *Ibid.*, Section 5.

Council on the Philippine Assistance Program, there were two institutions represented in the Board most involved in the nuts and bolts of aid programming, namely, the NEDA Secretariat and the Department of Finance. As the Secretariat of the NEDA Board, the former essentially performs staff functions relating to formulation of national and regional plans and public investment programs and coordination of their implementation. The latter performs a line function and is essentially responsible for raising tax and nontax revenues to finance government expenditures. Its legal mandate including those relating to aid are provided in another Executive Order.

Since aid is a major source of investment financing especially in the public sector and for securing technical assistance to institutions involved in implementation of development plans and projects, it seems justifiable that the NEDA Secretariat is involved in day-to-day activities relating to aid programming. Besides, the task essentially involves resource allocation which is so crucial in accomplishing its mission as a planning agency. In fact, it is organizationally structured to exercise this function, among others.

Aid can also be an important source of financing government expenditures, whether for investment (capital outlays) or for consumption (current operating or recurrent costs), can cover shortfall in tax revenues, can help in reducing the current account deficit (depending on the extent of aid tying) and in its financing and can even be a source of debt relief. Since aid provided in the form of loans carry concessional rates of interest and maturity, the financial cost of foreign borrowing through aid in the form of loans could be much lower than the cost of domestic borrowing. It would therefore be logical for officials and staff of the Department of Finance to also play an active role in the aid programming process.

While the two most active players in the aid programming process are one in seeing aid as a supplemental source of financing, they are not necessarily always

in agreement as to whether, how, when, and for what purpose aid will be availed of. The NEDA Secretariat, by virtue of its mission will necessarily want to use aid primarily as an instrument for promoting adequate and productive investments and their timely implementation so that development targets in real terms are achieved. Its orientation is in real terms and its perspective has a medium-term time horizon. To maximize efficiency in resource use, including aid, and the real development impact of aid in the longer run, it may be prepared to see some tradeoffs in timeliness of financial resource flows from aid in the short-run. The Department of Finance, on the other hand, by virtue of its mandate will want to use aid primarily as an instrument for reducing or financing the budget deficit or the BOP current account deficit and, if possible, for easing the debt burden now. Thus, the orientation is necessarily in financial terms and the perspective is essentially in the short-run. It may therefore be prepared to forego some economic growth and efficiency in resource use in the medium-term in the interest of timeliness of aid flows to make the financial accounts in order now or in the short-run. While not a member of the NEDA Board, the Central Bank, in view of its mandate to promote monetary stability, invariably shares the orientation and perspective of the Department of Finance.

Recalling the issue of fungibility of aid and the process by which aid provides the stimulus for moving towards a path of self-sustained growth, it would seem that absorbing aid now at less than optimum efficiency would be preferable than absorbing aid a year from now at optimum efficiency. As long as policies and procedures that promote productive investment and economic efficiency in total resource use are in place and functioning well and aid becomes part of total resources, it does not really matter too much or at all what items of expenditures are directly funded by aid. As we have pointed out earlier on several occasions, funds from aid or from any other sources are fungible. Aid is just a

part, albeit a major part, of total resources. What is crucial is that aid is absorbed now so that it *becomes* part of total resources together with domestic resources which it liberates and so that more aid may be forthcoming in the future, assuming more aid would still be needed. *After* aid becomes part of total resources, what is even more crucial is that total resources, including aid, are used productively now and in the future, not just aid now. Thus, whether aid is used directly for financing capital outlays or current operating expenditures seems to be less important than whether aid is actually being used at all.

Responsibility for Aid Programming in Other ASEAN Countries

Assignment of primary responsibility for aid programming to the planning agency is a common practice among aid-recipient countries of ASEAN-Philippines, Indonesia, Malaysia and Thailand—in line with the principle that aid is an additional resource which must be used to help achieve development targets and in accordance with development priorities. With respect to aid in the form of concessional loans, the planning agencies in all four countries coordinate with the Ministry of Finance in the sourcing of aid and in negotiation of financing terms and conditions.

As in the Philippines, aid programming in Indonesia is the primary responsibility of the National Development Planning Agency (BAPPENAS). Within BAPPENAS, the Bureau of Foreign Economic Cooperation prepares the list of projects for technical and capital assistance in grants and concessional loans for consideration of the aid consortium for Indonesia, known as the Inter-Governmental Group for Indonesia (IGGI) during its annual meeting. Projects which elicited interest from prospective donors/creditors are then evaluated by various sectoral Bureaus of BAPPENAS and approved for foreign

assistance by the Chairman of BAPPENAS who is also the State Minister for Development Planning. To ensure timely absorption of foreign aid, an inter-agency team chaired by the Chairman of BAPPENAS was created with a separate Bureau of Monitoring of Foreign Economic Cooperation Implementation within BAPPENAS providing Secretariat services.⁶³

In Malaysia, aid programming is the responsibility of the Economic Planning Unit (EPU) of the Prime Minister's Department. Within EPU "the External Assistance Section processes and coordinates application from various ministries for external technical and capital assistance including those from multilateral sources."⁶⁴ As in the case of NEDA in the Philippines and BAPPENAS in Indonesia, the EPU is staffed with sector specialists responsible for evaluation of various projects proposed for aid funding by various implementing ministries of the Malaysian government. Projects found consistent with development objectives and priorities are included in the development plan approved by the Cabinet and Parliament. Once included in the development plan, each project is documented and prepared up to the point that it is ready for funding and implementation unless EPU itself subsequently declares that in the course of detailed project preparation and evaluation, the viability of the project could not be established. After meeting all required project preparation and documentation, the covering grant or loan agreement is signed by the Director-General of EPU or an appropriate official of the Ministry of Finance, respectively.⁶⁵ Coordination

63. Interview with Directors of Bureau of Foreign Economic Cooperation, Bureau of Monitoring of Foreign Economic Cooperation Implementation and Bureau of Mining and Power, BAPPENAS, 1 August 1989.

64. Government of Malaysia, *Prime Minister's Department. Economic Planning Unit, Organization and Functions*, September 15, 1982.

65. Interview with Mrs. Hashimah Nik Jaafar, Assistant Director, External Assistance Section, Ms. Nor Fadzilah Yahaya, Principal Assistant Director, External Assistance Section and Mr. Mohamad Reaz Abdullah, Assistant Director, Economic Planning Unit, Prime Minister's Department, Government of Malaysia, August 4, 1989.

between EPU and the Ministry of Finance in the evaluation of projects for capital assistance, sourcing of assistance and negotiation and mobilization of assistance is done through the External Resource Committee composed of representatives from the two agencies.

In Thailand, aid programming responsibility is assigned to the Office of Prime Minister (OPM). Within the OPM, grants for technical assistance is administered by Department of Technical and Economic Cooperation (DTEC) while loans for financial assistance is programmed by the National Economic and Social Development Board (NESDB). Apart from programming the use of technical assistance, DTEC is also responsible for monitoring and facilitation of implementation of technical assistance projects. For the latter purpose, DTEC has a Project Finances Division which is responsible for receiving, budgeting and releasing cash proceeds from foreign grants and DTEC's revolving fund which is used for meeting local currency contribution of the Thai government.

To facilitate programming of aid for technical assistance, DTEC operates within the framework of a Technical Assistance Plan indicating sectoral and program priority areas together with project ideas. After each project is prepared by recipient agencies, it is evaluated by DTEC staff and approved by DTEC Sub-Committee on Technical Assistance Plan, except for projects for Japanese Grant-Aid and those constituting the UNDP Country Programme which are approved by the higher-level DTEC Committee.

With respect to loan assistance, each project proposed by implementing agencies is appraised by NESDB technical staff to verify its feasibility and consistency with national development objectives and priorities spelled out in the development plan. Upon favorable review, the NESDB Board endorses the project to the Cabinet for approval. If approved, the Cabinet then advises the Ministry of Finance to determine most appropriate sourcing of financial

assistance and to negotiate the terms and conditions of assistance. Prior to signing of loan agreement, the Ministry of Finance is required to obtain Cabinet approval of the loan agreement as negotiated.

The amount of loans for development projects which the Thai government obtains annually is approved by the Debt Policy committee chaired and provided technical support by the Ministry of Finance in the context of a three-year loan program prepared by NESDB and approved by the same committee, indicating sectoral allocation and taking into account readiness of proposed projects for implementation and absorptive capacity of implementing agencies.⁶⁶

Translating Pledges into Commitments: Further Considerations

Programming of aid available for investment financing and for a whole range of other purposes is necessarily more complex and time consuming. ESF is an example. ESF I (1981-1985) was used mainly for financing specific investment projects mostly in rural infrastructure (investment financing) and for project design and supervision (technical assistance in project preparation and project implementation). Money from ESF II (1986-1990) which had earlier been committed was used for financing local currency cost of IBRD and ADB-assisted investment projects (which may be viewed as a form of budget and BOP support) and for direct budget support through financing of specific items of current operating expenditures in the budget. For this type of aid, the first decision point is on a scheme of allocation between project assistance (investment financing) and nonproject assistance (budget support) which is acceptable to the donor.

Hurdling this decision point can take time. For example, the bulk of ESF money

66. Interview with officials of DTEC, NESDB and Ministry of Finance, government of Thailand, August 7-9, 1989.

pledged and available in 1988, that should have been committed by the end of the third quarter (end of United States fiscal year), did not become committed as of end of the year due to disagreement within the Philippine government and between the Philippine and U.S. governments on the amount to be programmed for budget support and on the conditionalities in terms of policy and institutional reforms being imposed by the U.S. government for using ESF money for budget support. We shall return to this in greater detail later.

Other sources of aid also allow some mix between project assistance and commodity assistance. These include Japan, Australia, FRG, Canada and the Netherlands. Unlike the U.S., however, these bilateral sources do not impose conditionalities, so far. Thus, determination of the amount to be programmed for commodities has not been as difficult. Except for Japan and the Netherlands, whose commodity loan assistance is untied in terms of procurement, determination of the amount for commodity assistance is often a function mainly of availability of commodities required by the Philippines in the donor country at a reasonably competitive price.

Another group of aid sources would simply specify the mix between capital assistance (investment financing) and technical assistance in terms of specific projects when the pledge is made as in the case of Italy, FRG, France and Denmark. IBRD and ADB indicate it in their lending and technical assistance programs together with proposed program and sector loans, if any.

Regardless of the specific purpose for which use of aid is agreed upon, some form of documentation would need to be negotiated and signed between the two parties as an obligation or commitment instrument. In the case of commodity assistance, a mutually acceptable listing of eligible commodities will have to be drawn up which becomes part of the agreement. Often, uses of local currency proceeds and its administration also have to be negotiated and agreed upon. In the

case of policy-based program loans and sector loans usually available from IBRD and ADB, policy conditionalities prescribed by the creditor have to be sorted out and debated within the government to determine their relevance and consistency with the overall economic and development policy framework before they are negotiated with creditors and subsequently accepted, modified or rejected.

In the case of project assistance (for investment financing or for technical assistance) specific projects will have to be identified, conceptualized, concretized and the necessary documents prepared by proponent agencies and reviewed by competent authorities in both recipient and donor/creditor to convince themselves and each other that those projects are worthy recipients of aid. In the case of technical assistance projects, the function of reviewing and the power of approving project proposals have implicitly been delegated by the NEDA Board to its Secretariat. Thus, the latter undertakes close scrutiny of every project proposal as documented by the proponent before it is endorsed to the prospective donor for review to see whether it meets certain standards in form and substance which have been set by itself and the donor/creditor. More specifically, the NEDA Secretariat would like to ensure:

- that the project is in line with the technical assistance requirements of the country for which medium-term technical assistance program approved by the NEDA Board has been formulated;
- that it does not duplicate or overlap with similar projects of other agencies of government and assisted by other donors/creditors;
- that it is not just a repetition of the same or similar project in the past which seemingly accomplished its institution-building

objectives only by way of providing vehicles and other logistics to the implementing agency;

- that the unit costs are reasonable and comparable to world competitive price so that real aid is maximized;
- that provision for foreign consultancy is not excessive so that it does not appear that the project is intended primarily to generate high-paying employment opportunities for foreign consultants;
- and that administrative arrangements for the implementation of the project do not make it appear as if foreign consultants are in charge of the project as they, in fact, were in many instances.

If the proposal does not measure up to the evaluation standards of the NEDA Secretariat, it is returned to the proponent agency with comments and suggestions as to how the project's design and its documentation should be modified and improved, assuming that the project can still stand modification and improvement. Otherwise, the proponent agency is advised to look around and submit a new proposal altogether.

All of the foregoing concerns of NEDA Secretariat which are translated into intensive review of project proposals, on behalf of the Board, are important and valid concerns to attain maximum value from aid and to promote utmost efficiency in aid use. Making itself concerned beyond the overall viability of the project and the project's consistency with development priorities is probably justified and even necessary for a planning agency whose mandate is essentially promotion of resource allocation efficiency, if no other agency is tasked to review such project implementing details as price competitiveness, consultancy fees, administrative and procurement arrangement, etc., and it has the manpower and other resources to perform such an intensive review. Foregoing review of such

details and making the implementing agency directly responsible and accountable for its action is, of course, always there as an alternative. For one, it would be in line with decentralization in decision-making which is an avowed policy of the Administration. For another, it would expedite processing of project proposals within government which in the end will have to be reviewed and agreed to by the donor/creditor.

In the case of project assistance for investment financing (capital assistance), the power of approval has explicitly been delegated to the Investment Coordination Committee (ICC), a smaller but still cabinet-level sub-committee of the NEDA Board, except in cases where the project involves policy issues with respect to the use of aid and to other aspects of development policy. The function of technical review, on the other hand, is assigned to the ICC Technical Board, another collegial body at the sub-committee level composed of senior officials with the rank of undersecretaries. They are members of the Technical Board by virtue of their regular position and functions in their respective departments/offices and therefore serve only on a part-time basis. Actually performing in-depth project evaluation is again the NEDA Secretariat whose findings and recommendations form as basis of the Technical Board's recommendation to ICC. It is seen from the foregoing that the decision-taking process in the case of capital assistance projects is much more lengthy and consumes more man-hours both at the staff and senior officials level.

As in the case of technical assistance projects, the concerns of the NEDA Secretariat, when investment projects proposed for capital assistance are received from proponent agencies, also go beyond overall feasibility and profitability and consistency with priorities and include project implementing details cited earlier. As in the case of technical assistance, staff limitation on the part of proponents and of NEDA Secretariat result in project proposals which are not adequately

prepared and in substantial backlog of proposed projects pending evaluation. The combined effect of poorly conceived/prepared projects entering a long pipeline for project evaluation and processing, the re-entry of many for the second and sometimes for the third time, and the resulting accumulation and clogging of projects in the pipeline is ultimately manifested in terms of slow translation of aid pledges for project assistance into commitment.

Reviewing the merits of a project beyond its overall viability and consistency with development objectives and priorities to include the previously cited project implementation details necessarily entails considerable amount of staff time and skills. Even with adequate staff in terms of quantity and quality, review of basic features of a project simply to determine its eligibility for foreign assistance from a specific source already takes sometime. If the staff performing the review function is inadequate and preparation and documentation of the project proposal is not satisfactory in form and substance to allow intelligent appraisal, project processing takes even more time. With donor multiplication, more than doubling of amount of aid to be committed mainly to projects, inadequate project preparation, inadequate staff, enlarged scope of review to obtain maximum real value from aid, processing of projects and their endorsement to prospective donors was bound to be delayed and their accumulation in the pipeline inevitable.

By early 1988, there emerged a perception that it was the procedure requiring each and every project proposal (including minor proposals for technical assistance costing less than \$1 million) to be submitted and scrutinized by the NEDA Secretariat which was delaying donor's approval of projects and effectively slowing down and reducing aid absorption. Upon strong representation of a number of line departments represented in the NEDA Board, a resolution was passed directing the NEDA Secretariat to *automatically* endorse to appropriate donors all project proposals for technical assistance (except for

feasibility studies) whose cost is \$1 million or less. The argument was that aid recipients know best what they need, aid donors would still evaluate the project and make the final decision to give aid even after the NEDA Secretariat undertakes its intensive evaluation, and the proposals involve relatively small amounts. The perception that the NEDA Secretariat was more of an obstructionist than a facilitator in the administration of aid was partly influenced by representations reportedly made by some donors that this or that project would have been approved for funding if the NEDA Secretariat had so endorsed it.

While the perception was that the problem was a matter of procedure, it was more than that in reality. When project proposals for technical assistance were automatically endorsed to prospective donors upon instruction of the NEDA Board, thereby rendering the function of the Secretariat akin to that of a postal entity, donor approval and aid commitment to specific projects hardly matched the number of endorsements. The real problem was that most projects were ill-prepared. Of course, it would have helped somehow if NEDA had adequate staff, not so much to tell proponent agencies that their projects were ill-prepared as to provide guidance and even assistance so that projects become well-prepared. The real solution would be to restore and/or build project preparation capacity among implementing agencies and aid recipients to facilitate intelligent appraisal.

While recipient agencies know best what they need in terms of technical assistance, they have to document their needs in a form and substance acceptable to donors in accordance with the latter's policies and procedures for aid-giving. Another party would have to appraise the urgency of the need relative to others if available aid is not adequate to address all needs, the feasibility of the project through which technical assistance will be provided, the adequacy of its documentation and the eligibility of the project, considering its input requirements, for foreign assistance. Whether the appraisal is done by the NEDA

Secretariat or directly by the donor is secondary. What is primarily important is that the proposal will lend itself to easy and intelligent appraisal.

When the NEDA Board directed its Secretariat to automatically endorse technical assistance proposals to prospective donors, it practically abdicated its aid programming power and function to the donors with respect to aid available for technical assistance which it had previously delegated to its Secretariat. Since technical assistance projects are by nature small in terms of cost relative to capital assistance and seldom exceed \$1 million, donors acquired the sole prerogative to determine whether technical assistance needs reflected in project proposals prepared and submitted by prospective aid-recipient agencies are important and urgent. If so and if aid available for technical assistance is inadequate to address all needs, to also determine which needs are more important and urgent than others. It would seem that this function which is central to NEDA's resource allocation task as a planning agency is something that it should continue to reserve for itself.

Considering the NEDA Board's function but recognizing the staffing limitation of its Secretariat, it would seem appropriate to continue to delegate the aid programming function to its secretariat rather than to waive it outright and completely abdicate it to donors. However, the breadth and depth of project appraisal to be performed by its Secretariat should be drastically reduced consistent with the function of aid programming and with staff limitation. In turn, project implementing agencies should be given full responsibility for aid use in the same manner that they are held fully responsible and accountable for implementing their respective projects.

To be consistent with the function delegated to it by the Board, namely, aid programming, and in light of its staff complement and structure as reorganized, the Secretariat should evaluate each and every project proposal but only to the

extent of validating its feasibility and profitability by itself and relative to each other, and of determining their eligibility for aid funding. To look into the design, input requirements and broad institutional arrangements for project implementation so that its feasibility and eligibility for aid funding may be confirmed and into the expected benefits so that its profitability and consistency with development priorities may be verified would be within the ambit of its responsibility. On the basis of this review, action may then be taken at least in terms of presenting and endorsing the project proposal for consideration of a prospective donor.

To look further into the details of the project including procurement modality, consultancy rates, shipping arrangements and costs, domestic and international competitiveness of inputs in price and in quality, detailed administrative arrangements for project implementation and for spending, accounting and monitoring of aid going into the project, etc. seems to go beyond what is necessary for aid programming purposes. While looking into these details is important to ensure maximum real value of aid received and utmost efficiency in aid use, these are matters for which aid users rather than aid programmers should be held fully responsible and accountable. The programmer's task is to allocate aid among competing users in a manner which is consistent with the objectives, constraints and priorities of development and in a form and at a time it is needed. Once aid is allocated and committed, the task of using it properly (in accordance with its intended purpose and with relevant rules and regulations), promptly and in accordance with schedule (so that project benefits are realized soonest), effectively (in the sense that project outputs are produced and objectives are attained) and efficiently (in the sense that real value of aid is maximized through arrangements which allow procurement of project inputs with the best quality at least cost) clearly belongs to the aid user and project implementor.

As a project implementing agency and as recipient of financial resources, including aid, it should take responsibility for implementing the project and should take complement or criticism for its success or failure in exercising that responsibility. By the same token, it should be held financially accountable to the Commission on Audit and appropriate authorities in the donor and recipient country, for aid and other resources used in the implementation of the project, regardless of whether it is an outstanding success or a miserable failure. In no case can the NEDA Secretariat or the Department of Budget and Management for that matter be held financially accountable for a project simply because it was reviewed and endorsed and funds were made available for its implementation.

To prevent the NEDA Secretariat from falling into the trap of reviewing proposals beyond what is called for in exercising its aid programming function, a more positive attitude of the NEDA Secretariat towards aid recipients is absolutely necessary. In turn, the NEDA Secretariat must be perceived by aid recipients as a facilitator rather than an obstructionist in the project development and aid programming process.

First of all, it must be presumed that recipient agencies know best what they need and what they do to fulfill their mandate and role in government. Second, in obtaining what they need and in spending and using what they obtain, it must also be presumed that recipient agencies are motivated by their obligation and desire to fulfill a mandate and will do so in light of applicable policies but subject to applicable rules and regulations. Thus, when a proposal is received, the NEDA Secretariat should look at it with a positive attitude and presume that the project is "good," i.e., that it can be done, should be done, and is a worthy recipient of aid. The task, therefore, is simply to validate that presumption and to establish priorities among "good" projects. In the event that the presumption is not fully validated, the Secretariat should then facilitate the required revisions, if it can,

rather than simply pointing them out, so that favorable action towards giving the proposal due course may be taken. This positive attitude may be further translated into sympathetic and positive behavior by looking more for justifications and reasons why a project must be given due course than why it must be aborted outright. At worst, it should have an open mind when a proposal is received.

In turn, aid recipient agencies must recognize the need for and the reality of a central authority and a neutral party within the government to review the multitude of proposals and requests coming from a host of prospective aid recipients with different missions and roles but towards a common purpose. Even though the NEDA Secretariat is unable to do it at this time for technical assistance upon directive of its Board and even if the NEDA Secretariat is unable to do it for all other projects for the same or another reason, another entity within the government, not necessarily confined to the Executive Branch, will have to do it eventually as a matter of national interest. Recipient agencies must see the review not as an attempt to "kill" or abort their project and a useless exercise merely obstructing the flow of aid as it is presumed that every project is a "good" project although it is just one of so many. They must also view it in a positive light as a useful effort to allocate scarce aid resources to where it is needed most and where it can be used most productively. They must recognize that this review will only be possible and will be facilitated and expedited if their projects are well-prepared and the proposals are properly documented. Most importantly, they must view the NEDA Secretariat (or whichever party undertakes the review) as a group whose reason for being is to program and to facilitate rather than to obstruct the use of aid and to help make a good project even better.

To facilitate programming of aid available for investment financing and for technical assistance, the Board directed its Secretariat to prepare rolling five-year public investment and technical assistance programs which were subsequently

approved but subject to annual updating and approval. As such, these two documents provide a coherent framework and a medium-term perspective with respect to the magnitude, nature and sectoral destination of planned public investments and technical assistance. While specific projects submitted by prospective aid recipients and implementing agencies are listed and their annual financial requirements are indicated, these projects are in various stages of implementation and preparation. Some are on-going and are nearing completion while others are nothing but project ideas or concepts with minimum documentation. Even though many projects which are not yet on-going are included in the program, not all of them have been approved for implementation. For most of them, approval of the Secretariat and the Board in the case of technical assistance and investment, respectively, would be necessary. In the process of annual updating, therefore, it is possible that some previously included may be withdrawn by implementing agencies.

Apart from providing the framework and medium-term perspective in aid programming, these two documents are also useful instruments for keeping track and evaluating how well planned investments, capital and technical assistance in terms of broad magnitude and sectoral destination and for specific on-going projects are being realized. They also serve as convenient sources of new project ideas from which one or a set may be presented to prospective donors in search of new projects so that their aid pledges could be committed.

When searching for new opportunities for public investment and technical assistance for which new pledges may be committed, these two documents, once again, should facilitate rather than absolutely constrict the search. A project proposed by an agency should not be automatically turned down simply because it is not in the program. In the first place, projects *in* the program all came from implementing agencies. Second, priorities within an agency, within a sector,

across sectors, or in the country as a whole can and do change within a year and this is precisely the reason why the two programs are rolling and updated every year. The change can happen sometime during the interim period rather than at the time of updating. Third, if there is no change in priority, an implementing agency has every right to change its decision regarding projects it wishes to pursue to accomplish its goals as long as they can be justified as feasible and profitable by itself and relative to others. In the same manner that the agency has the right to withdraw during updating or at other times projects previously submitted for consideration for aid funding as long as no commitment had been made, it should also have the right to submit new ones either as a substitute or in addition. As long as these additional or substitute projects are within the overall, sectoral or agency program framework and they do not unduly alter broad sectoral, regional or agency allocation of investment funds and foreign aid consistent with national policies and program priorities, they should be included in the search for new projects for aid commitment.

The change of government and, as a consequence, the change in the form of government, the reorganization of the bureaucracy and the extensive substitution of personnel in the career service of government had a strong impact on the aid administrative system particularly as it relates to aid programming. For one, it was the change in government which generated new and substantially more pledges of aid. For another, it occasioned the revival of development of new investment projects which had effectively been suspended during the years of economic recession and contraction simply because implementation of on-going projects could not even be sustained due to lack of budgetary resources. During those years, budgetary resources were preempted by expenditure for subsidies to government corporations and for bailing out private corporations which became bankrupt.

As there was a change in one of the most basic and fundamental institutions in society after 20 years which was supposed to happen every four or eight years, many other changes were engendered. Consistent with a change to a truly democratic form of government, policy-making and decision-taking also became genuinely democratic. A separate and independent legislative branch in government is now involved in broad policy setting and has exclusive authority in legislating enabling acts to implement certain policies, where necessary, and in authorizing expenditure of public funds, including proceeds from foreign aid. As representatives of the people, these public officials are rightfully concerned not only with enactment of legislation affecting the welfare of the country and the people in general. Particularly for members of the House of Representatives who are elected by their local constituents, they are also concerned and perhaps even more with acts of government that positively touch more directly and more immediately the lives of their constituents. The latter is certainly more effective than the former in gaining voter's confidence and support as their representative. These latter acts of government take the form of specific programs and projects whose benefits accrue to specific groups in society.

Since local government units barely have funds for day-to-day conduct of general government, funds for capital or developmental activities have to come from national government which the members of Congress have exclusive authority to appropriate. It is not surprising, therefore, that members of the Legislative Branch want an active role in identifying and selecting development projects. Since expenditures for foreign-assisted projects is relatively easier to justify particularly if foreign assistance is in grants, many projects suggested by members of Congress are foreign-assisted.

The issue as to how inputs from members of Congress should be handled by the Executive Branch and incorporated into the decision-making process affecting

resource allocation and more specifically aid allocation among projects and across geographic areas has not been satisfactorily resolved. At the regional⁶⁷ level, a Regional Assembly which includes Congressmen as members has been created to serve as forum for deliberation and consultation on matters affecting the region. As such, it is not a decision-making body unlike the Regional Development Council. The latter only includes members from the Executive Branch of the national government and from local government units. Consequently, membership in the Regional Assembly is not satisfactory to many members of Congress. At the national level, a joint Legislative-Executive Council has been proposed in two versions through bills filed in each of the two houses. The Council is to be chaired by the President and the members would include the Senate President and Speaker of the House of Representatives and selected members of the Cabinet. Its function is also deliberative and consultative with respect to broad policy directions. It is not yet known whether any of the two versions will be passed by Congress and signed into law by the President.

Meanwhile, proposals from Congressmen are being sent to line departments and NEDA Secretariat in Manila. Since projects which are regional in scope need to be endorsed by the concerned Regional Development Councils (RDCs), Congressmen are encouraged to submit their proposals to the RDCs. They are, however, generally reluctant to do so since their office and staff are in Manila and the RDCs are typically controlled by people who are usually their political competitor in the locality. Absence of standard procedures and guidelines for

67. The country is subdivided into 12 administrative regions. Each region is composed of provinces and chartered cities which are political sub-divisions governed by elected officials. Members of the House of Representatives are elected by congressional districts which comprise provinces and cities.

handling such proposals somehow contribute to the lengthening of the project development pipeline and to the difficulty in going through it.

The reorganization of the entire bureaucracy and the extensive substitution of appointed officials and staff, including those in the career service also had strong impact on the aid administrative system, both positively and negatively. On the positive side, the reorganization paved the way for the abolition of redundant agencies. For example, the Ministry of Human Settlements which had something to do with almost all facets of governance, including the power and function of programming the Economic Support Fund from the U.S. government ceased to exist although many of its internal organs and functions remained, e.g., ESF Secretariat, and simply transferred to other departments. On the negative side, it also occasioned resignation or retirement of a great number of career officials and technical staff, voluntarily or otherwise, who kept the aid administrative system functioning with fairly satisfactory result at least in terms of absorption, although not necessarily in terms of aid use efficiency when measured by output per unit of aid absorbed. These were officials and staff who had mastered the art of project development, i.e., translating the broad mandate of an agency into concrete projects, through "learning by doing," many of whom accumulated years of experience on the job. In at least two departments, all career officers from undersecretary down to division heads were replaced. In other departments, the substitution did not have the same breadth and depth. Nonetheless, substitution was still generally the rule rather than the exception. While the replacements were no less competent in terms of formal academic training, many lacked the experience of getting things done through the maze of a bureaucracy.

As departments and the units under each were abolished, merged or transferred and their functions were redefined, a new structure of the bureaucracy manned by a new set of bureaucrats emerged. The reorganization process took

place in 1986 and in the first half of 1987. As the process of bureaucratic restructuring went on for one and half years, many agencies had to await the final verdict on their respective mandate and specific functions embodied in separate executive orders. Since projects for investment or for technical assistance are concrete translation of an agency's broad mandate, functions and policies, identification of projects and their subsequent preparation for funding could not be undertaken immediately in a systematic and comprehensive manner pending issuance of the Executive Order prescribing the new and redefined functions of the agency. Thus, systematic project development which had been in a lull during the last four years of the previous political regime could only be revived in a real and systematic way in mid-1987. Prior to that, project identification had to be ad-hoc in nature, mostly in reaction to aid offers from time to time rather than based on a comprehensive review of the problems and potentials of the sector under the agency's jurisdiction and in light of the agency's role in the development and management of that sector as finally defined. To ensure congruence between the agency's mandate and policies, on the one hand, and its projects on the other, one agency decided to withdraw all projects previously identified, prepared and already in the pipeline for evaluation and replaced them with a new set. Meanwhile, the amount of aid pledges which had to be committed mostly for specific projects had significantly increased to \$3 billion in 1987 from \$1.3 billion in 1986. This is in so far as project identification and preparation are concerned.

Turning now to project evaluation, it would be timely to recall that this is the responsibility of the NEDA Secretariat. Like almost all other units of the bureaucracy, the organization of the NEDA Secretariat was restructured and its functions were redefined. Unlike many others, however, the size of its technical

staff (at least in the central office) and the number of senior officials (particularly at the undersecretary level) were reduced.

Prior to reorganization, the NEDA Secretariat was structured in accordance with functional differentiation. In turn, its functions were neatly differentiated in terms of the macro and micro aspects of development planning. On the macro side was planning and policy making which was the responsibility of one group—Planning and Policy office; on the micro side was project development and funds programming (including proceeds from foreign aid) which was the responsibility of another group—Programs and Projects office. There was, therefore, one group, headed by a senior official with a rank of undersecretary distinctly responsible for translating pledges into commitments, a process which we had earlier referred to as programming. While the thrust of the group's function was project feasibility evaluation in all aspects and regardless of the geographic scope of project benefits, it was also the group's function to assist implementing agencies in project preparation and identification, when needed and requested, and to deal with aid sources with respect to the terms, conditions and timing of the aid. The staff was adequate both in quantity and quality and composed of sector specialists in agriculture, industry, infrastructure and social services, and of development economists and financial analysts, all zeroing in on project development and programming of funds (including aid) for their implementation. As reorganized and in accordance with the policy of decentralization, which on the part of NEDA Secretariat means deconcentration of its development management function from the central office in Manila to the 12 regional offices, it is now structured in accordance with areal differentiation.

The two main groups are now National Development office, responsible for all planning, policy making, project development and investment programming which are national in scope and Regional Development office, responsible for the

same thing which is regional in scope. In addition, NEDA Secretariat now inhibits itself from assisting implementing agencies in project identification and preparation in order to avoid possible conflict of interest when the same projects are evaluated. Further, exercise of day-to-day responsibility for programming or for translating pledges into commitments now requires full cooperation from the Department of Finance particularly in cases where aid is available for investment financing and for other purposes. However, efforts to foster cooperation often result in competition between the NEDA Secretariat and the Department of Finance whose respective motives, attitudes and actions are influenced by the perspective and orientation we cited earlier.

Within the NEDA Secretariat, the function of evaluating projects whose area of influence is within a defined administrative region is supposed to have been devolved to the regional offices in accordance with the new structure and with the new policy that the locus of development management should be principally in the field (regions) rather than in Manila. However, the authority to determine whether a project proposal should already be endorsed to the donor (in the case of technical assistance projects) remains with the National Development office in Manila so that actions with respect to regional projects may be coordinated with those pertaining to national projects. Notwithstanding upgrading of the staffing pattern of regional offices, technical capacity for project evaluation (in all aspects of feasibility) in many regional offices is still inadequate. Consequently, projects already evaluated in the regions often had to be subjected to another round of evaluation in the National Development office in Manila. But there are now fewer technical staff in Manila both in terms of sector specialists and development economists as a result of reorganization. Further, the sector specialists in the National Development office are now responsible not only for project development (which was the sole function of sector specialists in the defunct

Programs and Projects office) but also for all other aspects of development planning and management in their respective sectors.

Within the National Development office, the responsibility to evaluate and, to some extent, the authority to determine and decide whether a project should already be endorsed to a specific donor (in the case of technical assistance) or should be presented to the ICC (for a go-no-go decision-taking in the case of capital assistance), a crucial decision point in the aid programming process, is lodged, in effect, to the Public Investment staff (PIS) composed of development economists and administrators. Accordingly, action papers and other documents relating to the exercise of such responsibility and authority emanate from this staff. While the function of technical evaluation of projects is carried out by the sector specialists belonging to other staffs, PIS also undertakes project evaluation for the purpose of establishing eligibility of a project for assistance from a specific donor/creditor. Further, it is responsible for day-to-day interaction with donors relating to programming and therefore bears most of the pressures for immediate attention and action demanded by the source of aid, on the one hand, and the prospective recipients, on the other. Furthermore, it is also responsible for formulation and updating of investment and technical assistance programs and for issuing guidelines for project evaluation, including estimates of shadow prices, for guidance of the regional offices and other staffs of the NEDA Secretariat. Within the NEDA Secretariat, there are simply too many functions assigned to this staff. As a consequence, it is practically overwhelmed by the sheer volume of paper work, by the number of visitors/callers it must deal with from both sides and by the pressures brought to bear which have to be either absorbed or warded off.

With inadequate staff, multiplication of the number of donors/creditors, and more than doubling of the volume of aid pledges to be committed, hurdling the

aforecited decision point for which the Public Investment staff is primarily responsible has become the principal bottleneck in the process of translating aid pledges into commitments.

One other point deserves attention in the aid programming process in the Philippines, namely, the rate of return on investment which is deemed acceptable. Based on estimates of opportunity cost of capital and other project planning parameters made by the NEDA Secretariat and the Philippine Institute for Development Studies in late 1970s, the Philippine government even under the previous regime has been using 15 percent as the hurdle rate for an acceptable economic return on investment. Thus, if the benefits of a project are such that quantification is possible, an EIRR of 15 percent must be met for it to be considered acceptable. A number of proposed investment projects could not be presented to the ICC or when presented, rejected or remanded to the proponent agency for redesign either because the EIRR was short of 15 percent or only marginally higher than 15 percent so that when sensitivity analyses were performed minor deviation from assumptions made in the base case immediately rendered the project unprofitable. Based on inquiries with appraisal missions of creditors, the World Bank is reportedly using a lower standard of economic rate of return at 12 percent and even lower than that in the case of KfW of the Federal Republic of Germany when they do their own project appraisal. With more access now of the Philippines to the international capital market, it is possible that the real scarcity value of capital has in fact declined in the Philippines which may warrant reduction of its economic profitability standards and, as a result, enhancement of its aid absorptive capacity. Since estimates were done in the 1970s yet, it would definitely be appropriate and necessary to update them in any case to either revalidate or revise them.

The Philippine government may also wish to consider the adjustment in calculation of EIRR and other economic profitability indicators referred to in Chapter III to take account of differences in economic cost of foreign aid used for investment financing. As pointed out in Chapter III, the economic opportunity cost of aid differs depending on the terms and extent of tying.

Translating Aid Pledges into Commitments: Some Specific Cases

In this section, we shall look at the process involved and the difficulties encountered in translating pledges of aid from four specific sources and examine why they emerged and how they may be effectively addressed, if not resolved, so that commitment of aid may be facilitated in the future. We shall select cases involving translation of aid pledges into commitments, ranging from one whose aid is available only for investment financing to others whose aid is increasingly available also for financing of current imports and financing of government current consumption.

Denmark: Aid Available Only for Investment Financing

Denmark has been a source of foreign aid to the Philippines since early 1970s for financing of investment in irrigation, water supply, food storage and processing and maritime training. Danish aid may be used for procurement of equipment and engineering and other consulting services for detailed project design, construction supervision and feasibility studies for project preparation. Although relatively small in amount and provided entirely as a loan, the terms are very concessional (no interest, 50 years maturity including 10 years grace). However, it is completely tied to specific projects and almost completely to foreign exchange cost eligible for expenditure only on goods and services supplied by Danish firms and nationals.

In early 1988, it made a pledge of DKK100 million through a mission dispatched on March 20-25 for commitment within the same year. Another mission was dispatched towards the latter part of the year (August 22-September 2) during which an additional pledge of DKK100 million was made for commitment in 1989.

As of end of 1988, no commitment of funds had been made whatsoever. The only progress made as of that date was the identification of projects for which aid will be committed, two thirds of which will be for continuation of an on-going water supply project financed under a previous loan.

In line with the policy of channeling aid available for investment financing to projects specifically included in the government's investment program, the NEDA Secretariat presented to the March Mission a list of projects drawn from the program. None, however, elicited any interest from the mission, not because the projects were deemed unfeasible (since they were still to be subjected to feasibility studies) but because none did not seem to require equipment and services which could be sourced from Denmark in sufficient quantities.

No commitment had been made not because there was disagreement within the government of the recipient country as to how aid will be used since it had been made clear from the outset that Danish aid is available only for investment financing (including pre-investment activities) and for projects whose inputs will have to be sourced almost completely from the creditor country. To some extent, failure to commit any amount by the end of 1988 was due to absence of projects which were sufficiently prepared for Danish assistance. For the most part, however, it was because none of the new project concepts/ideas within the government's investment program earlier presented to Danish authorities elicited interest. Otherwise, some might have been selected and promptly subjected to

feasibility studies so that appraisal, loan negotiation and other activities leading to loan commitment could be subsequently undertaken.

In this particular case, it was not so much availability of projects with acceptable rate of return as the factor effectively constraining commitment and subsequent absorption of aid. Rather, it was availability of equipment/services which the recipient is able and willing to buy and the donor is able and willing to sell.

As previously pointed out, if the underlying motive for aid-giving is commercial, i.e., to sell, the appropriate aid modality for realizing it would be through a commodity aid (rather than project aid) involving straightforward identification and packaging of commodities (including services as required) which the recipient and donor can and want to buy and sell, respectively. This is actually practiced in the case of several other bilateral donors, e.g., U.S. in the case of food aid under P.L. 480 and Section 416, Japan through OECF's commodity loan, Australia, Federal Republic of Germany, Canada and Netherlands. Through the commodity aid facility, aid is committed and absorbed more quickly as it avoids the hassle of "projectizing" the aid, which means going through the project development process including the motion of convincing each other and all concerned parties within the recipient and donor countries that the project is "good" when in fact, even if it is, aid will not be committed for its implementation if there is no prospective sale from donor to recipient.

Italy: Aid Available for Investment Financing and for Technical Assistance

Italy is one of several new sources of aid to the Philippines which emerged after the change of government. Based on the amount of aid pledged in September 1987 for commitment within a three-year period amounting to \$270 million (\$180 in loans and \$90 in grants), Italy became the largest among

European bilateral sources of aid and third largest among all bilateral sources, next to Japan and the United States. Terms of loan assistance are less concessional than that of Denmark at 1.5 percent interest with 30 years maturity, including 10 years grace period but more concessional than that of Japan. Aid is tied to specific projects either for investment financing or for technical assistance in the form of engineering and other consulting services for feasibility studies, detailed design, construction supervision, research and development and general institution building. At least 85 percent of aid is tied to foreign exchange cost and to Italy as a source of procurement. Up to 15 percent of aid earmarked for a project may be used to cover local currency cost.

Somewhat unique is the requirement that Italian consultants and contractors (for equipment supply and civil works) may be selected and hired by the recipient country in the case of aid provided in loans but not in the case of aid provided in grants. Consultants and contractors in the case of the latter are selected and hired by the donor country.

Let us first consider aid pledged in grants. When the amount of \$90 million was pledged in September 1987, \$47.7 million were already earmarked for nine specifically identified technical assistance projects "ready for implementation" and \$14 million for eight projects "for further consideration," or a total of \$61.7 million, representing more than two thirds of amount pledged. In addition, there were 25 "newly identified projects" for which no earmarking was made as they were mostly project concepts with limited documentation. As of end of December 1988, \$30 million or one-third had been committed through Memorandum of Understanding, most of which were signed during the state visit of the President to Italy in June 1988. No disbursement had been made, however, as of end of December 1988.

Unlike in the previous case of Denmark, the problem was not one of scarcity of projects which elicited interest from the donor/creditor country. In fact, there were 42 projects listed in the Protocol of Understanding documenting the aid pledge which may look too many for a \$90 million grant. But the Italian case differs in many respects compared (see Table V-1) with the case of Denmark even though both are triple-tied to projects, to foreign exchange cost and to source of procurement. First, Italian aid has a substantial grant component. Second, apart from investment financing, it is also available for a whole range of technical assistance activities. Third, it is programmable for service-oriented private sector projects. Fourth, projects presented and included in the Protocol did not come exclusively from the approved public investment and technical assistance programs. There was therefore a lot more elbow room in the search and selection of projects for Italian Assistance. Since aid was available for private sector projects, the search for projects was not confined to the public sector's investment and technical assistance program. In addition, the Italian private sector proved to be much more active in assisting and prodding both government and private institutions in the Philippines to prepare and submit project proposals in anticipation of the forthcoming pledge of aid from the Italian government.

As in the case of grants, the amount of \$180 million in loans pledged in September 1987 was earmarked for four specific projects. They were, however, at different stages of preparedness. Two (Bacon-Manito Power and Balog-Balog Irrigation) had completed feasibility studies but still pending review by the NEDA Secretariat. One only had some kind of pre-feasibility study (Mindanao Telecommunications) forming part of a National Telecommunication Master Plan while another (Spare Parts for Power Plant) still had to be documented in terms of specific items and quantities. Notwithstanding the earmarking, no commitment in terms of signed loan agreement with Medio Credito, the Italian financing

TABLE V-1 Philippines: Comparative Aid Features from Four Selected Sources and Progress of Commitment of Most Recent Pledges				
Item	Denmark	Italy	Japan	U.S.
Amount Pledged	-	\$270 million	\$829 million	\$262 million
Grant	-	\$90 million	\$236 million	\$232 million
Loan	DKK 100 million	\$180 million	\$593 million	\$30 million
Date of Pledging	March 1988	Sept. 1987	Grant: June 1988 Loan: 4th quarter 1988	Undetermined
Planned Period within which Pledges are Committed	Nine Months Ending December 1988	3 Years Ending September 1990	Immediately after pledging but not later than end of Fiscal Year ending March 1989	Approximately One Year Ending September 1988
Amount Committed as of December 1988	None	Grant: \$30 M Loan: None	Total: \$805 M Grant: \$212 M Loan \$593 M	Grant: \$58 M Loan: \$30 M
Terms of Aid (Loan Terms: Expressed in the following order: interest, maturity, grace)	Loan (0, 50, 10)	Grant and Loan (1.5, 30, 10)	Grant and Loan (3, 40, 10)	Grant and Loan (2-3, 40, 10)
Nature and Extent of Restriction in Aid Use:				
Purpose of Expenditure for Aid Financing	Investment and Pre-Investment	Investment, Pre-Investment and Technical Assistance	Investment, Pre-Investment, Technical Assistance, Current Imports	Investment, Pre-Investment, Technical Assistance, Current Imports and Government Current Consumption
Aid Modality	Project	Project	Project and Non-Project	Project and Non-Project
Nature of Cost Eligible for Aid Financing	Mainly Foreign Exchange Around 10 percent Local Currency	Mainly Foreign Exchange Around 15 percent Local Currency	Mainly Foreign Exchange Around 20-30 percent Local Currency	Mainly Local Currency
Source of Procurement	Mainly Donor Country, Procurement Tied to Donor & Recipient Countries	Mainly Donor Country, Procurement Tied to Donor & Recipient Countries	Mainly Donor Country, Procurement Partially Untied with Respect to Services and Completely Untied with Respect to Commodities	Mainly Recipient Country
Ultimate Recipient	Public Sector	Public & Service-Oriented Private Sector	Public and Profit-Oriented Private Sector	Public and both profit- and service-oriented private sector

institution in charge of administering government aid in loans, had been made as of end of 1988. During the state visit of the President, a brief document entitled "Credit Agreement" was signed for two projects between the two governments. The document, however, simply formalized the pledge and would not yet allow drawdown from the loans.

As things stood as of end of 1988, it was not clear whether loan agreements with Medio Credito could be signed by end of 1989 or whether disbursements could be realized in the case of grants for which commitments had been made. Meanwhile, a high-level mission was dispatched by the Italian government in January 1989 to look into the difficulties encountered towards committing and disbursing Italian aid pledged in 1987 and to look into the possibility of making another pledge even before the first three-year programming cycle terminates in September 1990, \$50 million of which would be in grants for the agrarian reform program. The Mission left the impression that a second pledge before 1990 is possible if good progress can be made in the absorption of the first pledge.

Difficulties encountered in the process of absorbing Italian aid derive mainly from the fact that Italy is a new source whose policies and procedures in aid-giving are quite different from traditional sources. Its private sector apparently plays a much more active role in aid programming and is quite open about it compared to other bilateral sources. Pressure from prospective suppliers to make the aid committed promptly has not been too effective and in some cases delayed the process even more. Bureaucrats from both recipient and donor countries are still learning each other's system, policies and procedures for aid administration.

Absence of standard procedures within the Philippine government for channeling aid to local government units and to service-oriented private sector had also been a source of difficulty. Consistent with the avowed policy of

decentralization, including devolution and privatization, local government units and service-oriented private sector entities are increasingly becoming target recipients of aid, pursuant to that policy. While the broad policy is to allow, if not encourage, aid to be channeled to such entities, detailed guidelines and standard procedures for that purpose have not been formulated and adopted in any institutionalized fashion.

Let us consider specifically the Davao Integrated and the Peace and Reconciliation projects whose implementing agency and ultimate aid recipient are Davao del Norte Provincial government—a local government unit—and Xavier University Foundation—a service-oriented private institution, respectively. In both cases, one policy and legal issue was whether a provincial government and a nongovernment organization can and should carry out the obligations of the national government prescribed in the Memorandum of Understanding (MOU) relating to the implementation of the project including use of Italian aid and provision of local counterpart funds, and be duly designated for that purpose in the MOU. Since the project implementing agencies and ultimate aid recipients are not part of the national government structure, one alternative was to make them directly responsible and accountable for implementing the project, for providing local currency and other inputs not funded by Italian aid, and for spending project funds from aid and from their own sources. In view of the fact that Italian aid is provided by the Italian government to the Philippine government, an agency of the national government must represent it (the national government) as aid recipient although it may assign its responsibilities to other entities. Thus, the national government would still assume primary responsibility. The previously mentioned alternative therefore was not feasible. Nor was it preferred by any of the concerned parties. Not by the donor since its preference was to deal with one focal point within the national government rather than directly with each and

every aid recipient for ease in aid administration. Not by the national government since it reserves the right to provide an oversight in aid programming and aid use including those channeled to LGUs and NGOs. Even for aid provided by NGOs from donor countries to local NGOs, the national government would like, at the very least, to monitor where such aid is going and how it is being used. Not by the provincial government—while it did not mind receiving aid directly from Italy, it was not prepared to be held directly responsible for providing the local currency and other inputs required by the project and was looking up to the Department of Budget and Management for that purpose. Not by Xavier University Foundation at least with respect to the provision of all other project inputs as it was prepared to commit only land in the project site as its direct responsibility.

Up to the time that negotiations in the drafting of the MOUs had to be finalized in time for signing on the occasion of the Presidential state visit in June 1988, the Philippine panel was unable to receive advice as regards resolution of the issue. Pending resolution of the issue and in the interest of getting the aid committed, the Regional Development Council—a collegial body whose Chairman is appointed by and reports to the President and whose functions essentially involve development management, including implementation of projects, at the regional level—was found as mutually acceptable entity to which responsibilities of the national government for project implementation was assigned, without prejudice to partially or fully passing on such responsibilities to the provincial government and to Xavier University Foundation.

Let us consider next two other projects—Balog-Balog Irrigation and Bacon-Manito Power—which were identified for commitment of Italian aid in September 1987 under the loan component. Pipelining both projects for Italian assistance encountered difficulties from the very beginning for two different

reasons. The former had doubtful economic profitability while the latter was originally pipelined for IBRD assistance as the core component of a bigger loan package.

Establishing the economic profitability of the Balog-Balog irrigation project involved a long series of evaluation by the NEDA Secretariat, deliberation by the ICC and its Technical Board and re-design/re-packaging of the project by the National Irrigation Administration. It was only after the project went back and forth from the implementing agency to the NEDA Secretariat and to the ICC and after its cost was scaled down considerably through removal of the power component and some flood control components which originally justified its multi-purpose nature that the project was finally declared feasible and favorably decided upon for implementation and for Italian assistance.

The Bacon Manito Power project seeks to develop and exploit geothermal energy (natural steam) for power generation. Due to increased demand for power as economic recovery got underway and the relatively lower cost of geothermal power compared to hydro, coal-fired and oil-fired thermal power sources, its economic profitability was never in doubt. Thus, IBRD, which had recommended to Philippine authorities removal of Balog-Balog from the public investment program notwithstanding the fact that it funded the project's feasibility study and engineering design, had always included Bacon-Manito in its lending program to the Philippines. Unlike Italy, however, which formalizes its pledge in writing, IBRD does not. Nonetheless, IBRD sent a series of missions for the project's preparation and appraisal and, in fact, funded its pre-investment activities.

For quite some time, sourcing of the assistance was an issue and delayed somewhat the process of translating both IBRD and Italian pledges into actual commitment. IBRD assistance carries harder financial terms but it is not tied and a higher proportion may be used for financing local costs. In addition, it will

finance components other than the power plant, i.e., exploration of other geothermal fields, improvement of power distribution facilities in Metropolitan Manila, etc. Thus, withdrawing Bacon-Manito from the IBRD pipeline completely after withdrawal of several projects earlier may jeopardize a bigger loan package. Furthermore, it may strain further the government's relations with IBRD which continue to be a major source of quick disbursing, policy-based, and nonproject type of aid. Italy, on the other hand, is a new source of potentially substantial aid whose terms are extremely concessional although its use is necessarily tied with respect to procurement. Computation of value of real aid under these circumstances would have been appropriate as concrete basis for decision making and would have been done easily since there are reportedly only two other countries selling geothermal power equipment. The final decision was to seek joint financing, i.e., to withdraw financing of the acquisition of power equipment from IBRD so that Italian aid may be used instead but retaining the civil works, geothermal field exploration and power distribution components for IBRD financing.

Following that decision, an IBRD loan was promptly negotiated sometime in mid-1988 and committed by year-end. Italian portion, however, remained uncommitted for two reasons. The first had something to do with the requirement of the creditor that a loan agreement may be negotiated only after a contract for the supply of equipment and/or civil works had been concluded and entered into with an Italian firm and duly approved by Italian authorities. Note that the usual procedure is the reverse, i.e., a loan agreement is a pre-requisite and serves as basis for negotiating a contract with prospective supplier of goods/services. If the procedure had not been reversed, a loan agreement might have been similarly concluded as in the case of IBRD.

The second reason had to do with contracting procedures. An Italian firm had been representing itself as the sole supplier of geothermal power equipment in Italy and had served notice of readiness to negotiate a contract based on a draft it had sent to the National Power Corporation (NPC)—the project's implementing agency. Under both Italian and Philippine laws, direct negotiation would be possible if there is, in fact, only one supplier. Since aid is tied to Italian suppliers, immediate negotiation would have facilitated the contracting process. In view of the fact that Contracting Guidelines issued by the Philippine government prescribe competitive procurement under normal circumstances, NPC decided to go through the whole process of bidding, including solicitation of interest, shortlisting, etc. to make sure that, in fact, there is only one supplier and, if more than one, that there is competition. This decision further delayed the commissioning of the power plant which was originally set for 1990. Because of similar delays in the commissioning of another new plant (coal-fired thermal) and the rehabilitation of an old plant (oil-fired thermal) in the Luzon Grid, a package of gas turbines which can be commissioned within a shorter period of time but produce power at a higher cost will have to be relied upon to supply the increasing power requirements in the interim period between 1990 and until the aforementioned plants under construction and rehabilitation become operational.

It is seen in the case of Bacon-Manito Power that delays in project implementation and plant commissioning owing partly to delays in aid commitment and absorption can bring about economic costs. Clearly, there is again a trade-off between gains or benefits in terms of maximizing value of real aid achieved through careful sourcing of foreign aid and strict adherence to competitive procurement procedures, on the one hand, and costs arising from delays in decision-making and in aid commitment, on the other. Whether the benefits justified the costs will only be known exactly on an *ex-post* and

case-by-case basis. It is, however, incumbent upon the aid administrative system to figure this out, *ex-ante*, in the aid programming process, hopefully guided by lessons from actual experience in the past, so that overall net benefit from aid, i.e., net of cost of delays, may be maximized.

Delay in commitment of Italian assistance to Balog-Balog project even after its implementation was finally approved is attributable to aid-tying with respect to source of procurement. Because of exclusion of power component from the project, equipment requirement and therefore foreign exchange cost component of the project was substantially reduced. To fully utilize Italian aid of \$85 million which is tied to Italian suppliers, a considerable proportion will have to be spent on services and materials particularly for civil works in site preparation and in construction of dam, main canals and other water distribution facilities which can be supplied locally. Because of aid-tying, Italian aid can only be expended for payment to Italian suppliers. Therefore, to allow supply of services and materials from local sources paid from proceeds of Italian aid, local suppliers can only be sub-contractors of Italian firms which will be the prime or main contractor.

In view of the foregoing, the National Irrigation Administration (NIA) confined its solicitation of interest, shortlisting or prequalification, and invitation of bid to Italian suppliers. Selection of contractor, however, was deferred and may be aborted in view of representations of local contractors to be included in the bidding process as main contractors. Local contractors had demonstrated their competence in building similar infrastructure facilities of the same magnitude in the past. As of December 1988, no contractor had been selected and it was not known when or whether Italian aid will be committed at all to help finance the project. Meanwhile, NIA had started site preparation using local resources.

Commitment of Italian aid to the project is possible only after a contractor is selected and a contract is concluded and approved. If local contractors are

included in the bidding process and one of them wins, Italian aid cannot be used because it is tied to payment to Italian contractors. The alternative therefore would be to forego Italian aid and rely completely on local resources. This action, however, may strain diplomatic relations and may jeopardize future Italian aid.

If all concerned parties—local contractors, Italian contractors, NIA, competent authorities in recipient and donor governments—will agree, a happy compromise would be to encourage Italian and Filipino contractors to enter into joint venture, to allow inclusion of Italian-Filipino joint venture in the bidding process and, if one of them should win, to use Italian aid for direct payment to goods and services supplied by the joint venture and sourced from either the donor or recipient country. This, however, would delay project implementation as it would mean going through the bidding and selection process for the second time and would not ensure selection of an Italian-Filipino joint venture. It can, however, save commitment of Italian aid to the project, albeit delayed, and minimize jeopardy to future Italian aid.

Japan: Aid Available for Investment Financing, Technical Assistance and Current Imports

Since the beginning of the 1980s, Japan has been the biggest source of foreign aid to the Philippines, on commitment basis, except in 1986 when the U.S. committed more in ESF money. Japanese aid is provided both in grants administered through Japan International Cooperation Agency (JICA) and in loans (3 percent interest, 40 years maturity, 10 years grace) through Overseas Economic Cooperation Fund (OECF). The former is intended for technical assistance under the Technical Cooperation Program (TCP) and also for investment in the social sector under the Grant-Aid Program, usually for training facilities or health facilities/equipment, for which economic rate of return calculation is hardly undertaken because it is considered either unnecessary or

impossible. The latter is intended for investment financing both in the public and private sector, through project loans, for financing current imports through commodity loans, and for financing other items in the balance of payments through "co-financing" schemes with IBRD and ADB. In 1985, part of the loan package was committed for "re-financing" of debt service.

Aid provided in grant is tied to Japan with respect to procurement. Aid in loan through OECF is partially untied, i.e., host country and other less developed countries (LDCs) also become eligible sources, when used for procurement of consultancy services and completely untied, i.e., other developed countries in addition to the aforementioned sources also become eligible, when used for procurement of goods.

It will be noted from Table V-1 that the entire amount pledged in the middle and last quarter of 1988 had almost completely been committed by year end. The reason for this is that, in the case of Japan, a pledge in writing is almost as good as a commitment. In the case of grants, pledge of aid to specific projects is manifested in the Record of Discussions between the Philippine government and the Mission dispatched annually by the Japanese government sometime in June. This is quickly followed by a formal commitment but not later than March (end of fiscal year) of the following year through Exchange of Diplomatic Notes. Presentation of the projects, however, is made to the Mission which came during the preceding year. In the case of loans, pledge of aid is made already through Exchange of Diplomatic Notes but only after projects have been thoroughly appraised by OECF and selected for appraisal by an inter-agency Japanese Mission. Loan negotiation and signing of loan document as an instrument of loan commitment then follows immediately.

In the case of grants, especially under the Grant-Aid program which is available for investment in social infrastructure, there was no difficulty in terms

of supply of projects for presentation to Japanese Mission for several reasons. First, through the Grant-Aid program, Japan is the only source of aid in grant which can be used directly for construction and/or for providing equipment to health, training and similar facilities in the social and agriculture sectors. Second, the only required counterpart contribution from the recipient agency is land during the construction stage and the facility is practically delivered on a turn-key basis. Local currency contribution becomes necessary only after construction is completed for the project's operation and maintenance. Third, as in the case of Italy, prospective Japanese suppliers actively assist (although in much more discrete ways) prospective aid recipient agencies in project identification, preparation and documentation. Fourth, although projects under this program are capital forming, foreign-assisted and may be considered as "major" in terms of cost, it does not go through the Investment Coordination committee and the NEDA Board approval presumably because foreign assistance is provided in grant.⁶⁸

While programming of aid available for investment financing was generally hampered by lack of identified and prepared projects, the problem under the Japanese Grant-Aid program was that there were too many of them for reasons earlier cited and the difficulty was in the matter of prioritization and selection. Since both the function to review projects and the power to approve them for implementation and funding under the Japanese Grant-Aid program are implicitly delegated to the NEDA Secretariat, it must perform the task of making a choice among so many for presentation to and consideration of the Japanese government. Until 1987, it had the will to make that choice based on some set of criteria and in

68. Pursuant to the Foreign Borrowing Law, NEDA Board Resolution is necessary prior to loan negotiation.

line with its funds programming responsibility and authority delegated by its Board. Sadly enough, it lost the will in 1988 when it desisted from making that choice and, in effect, abdicated its aid programming responsibility and authority. They were passed on partly backward to line departments and partly forward to the donor.

Let us first examine why and then explain how. The basic and fundamental reason for NEDA Secretariat's voluntary abdication of power with respect to programming of Japanese Grant-Aid was its being caught in a dilemma, or as the saying goes, between a rock and a hard place. On the one hand, it was under pressure from implementing agencies, from its Board and from the donor to take immediate action in terms of endorsing to the Japanese government a set of projects for discussion with a Mission forthcoming in June 1988. It will be recalled that by early 1988, it was suffering from the perception that its scrutiny of each and every project was causing delays in aid flow. Because of favorable features of the Grant-Aid program, competition among prospective recipients was particularly keen, to say the least. This is translated into around 100 proposals, of which only three to six, depending on project cost, can be accommodated annually. On the other hand, it felt that it should select projects in a manner and with an outcome which it can justify to everyone, particularly to those whose projects were not chosen. But to do it in a truly objective and democratic fashion so that the choice becomes justifiable to everyone would take time if it is possible at all. Unlike public investment in economic infrastructure, e.g., power, irrigation, those in social infrastructure e.g., hospitals, training centers, which are typically submitted for Japanese Grant-Aid are not comparable in terms of quantified economic rates of return simply because their EIRR is not estimated. Cost effectiveness indicators, being measures of cost per unit of effect (see Chapter III), do not offer a satisfactory alternative either, particularly when projects being

evaluated and compared have different effects. A hospital project costing P10,000 per sickness cured may be considered acceptable from a cost-effectiveness standpoint based on some subjective judgment. Whether it is preferable to a training center costing P10,000 per trainee in a three-month course say, in auto mechanic, would again be a matter of subjective judgment which would partly depend on whether a healthy population is considered more or less important than a skilled population in the hierarchy of development priorities.

One way of addressing a need would be to eliminate it. The need to establish priorities and to make a choice on the part of the NEDA Secretariat was eliminated when it asked line departments to establish their own priorities among proposals submitted by their respective bureaus and agencies. What the Secretariat did was simply to endorse all top priority projects indicated by the heads of line departments to the Japanese government. The Japanese government then exercised its programming prerogative by choosing three projects for which assistance was pledged with assurances that it will consider the rest for funding within the next three years.⁶⁹

In the past, the NEDA Secretariat managed to exercise its aid programming responsibility and authority under the Japanese Grant-Aid program by selecting and endorsing to the Japanese government only a limited set of projects whose aggregate cost matched or barely exceeded what was known to be available for programming (around six billion yen annually). For reasons earlier mentioned, the approach taken in project prioritization necessarily relied heavily on subjective judgments. Project priorities within a sector were essentially determined by sector specialists within the NEDA Secretariat and across sectors

69. Minutes of the 12th Japan-Philippines Annual Consultation on Technical Cooperation and Grant-Aid (June 22-24, 1988), p. 14.

by higher officials. Equity in aid distribution, specifically Japanese aid under the Grant-Aid program, across sectors, regions and recipient agencies was considered as a significant criterion. And so was judgment with respect to magnitude, importance and urgency of relative need for aid. Use of expert judgment by sector specialists in establishing priorities and decision-taking through democratic processes were attempted to the extent possible. These attempts were sometimes thwarted by direct instructions from higher authorities, either verbally or through marginal notes. Thus, from time to time, aid programming authority was, in effect, being withdrawn. While this was not particularly encouraging, it did not prevent the Secretariat from continuing to perform its aid programming function, recognizing that its authority to approve and select projects for aid funding is only a delegated power which may be withdrawn *any time* and *from time to time*. The function to review projects continued to be undertaken and the power to approve and select them for Japanese grant funding was exercised unless otherwise told.

The situation with respect to projects for loan funding through OECF was exactly the opposite. Even though the Japanese government agreed to provide around one half of its most recent pledge in loans (15th Yen Package) for commodities and co-financing with IBRD and ADB, a good number of projects was still necessary to absorb the remainder. Difficulty in packaging a sufficient number of projects for yen loan funding delayed dispatch of project identification mission from the Japanese government and appraisal mission from OECF which should have been made in the second quarter instead of the fourth quarter of the year.

In anticipation of a substantial increase in the amount of aid to be pledged under the 15th Yen Package and to avoid further delay in obtaining the pledge and translating it into commitment, two projects originally pipelined for IBRD assistance (whose terms are relatively harder) had to be withdrawn and one

project for which Japanese funding had earlier been committed through another credit window had to be reconsidered.

Of the eight projects for which Japanese loan aid was committed under the project component of the 15th Yen Package, two (Metro-Cebu Development and Metro Manila Urban Transportation) were originally pipelined for IBRD assistance while one (Palimpinon Geothermal Power II) had previous loan commitment from Japan through its Export-Import Bank.

To make up for delay in project appraisal and loan commitment under the 15th Yen Package, the Japanese government indicated its readiness to make the appraisal for the 16th Yen Package before the end of its fiscal year in March 1989 if there are sufficient projects submitted by the Philippine government by then.

Packaging of sufficient number of projects which had gone through review and screening process of the aid administrative system will continue to be difficult and commitment of the 16th Yen Package will again be untimely unless the recipient dramatically improves its project development and processing capability or unless the creditor agrees to increasingly program the annual yen credit for nonproject assistance.

On the part of implementing agencies, more systematic and sustained efforts at project identification and preparation either for investment and for technical assistance would be necessary. To make this possible, more financial resources should be made available to them, either from internal sources or from the donors, to strengthen their in-house capability or, alternatively, to contract domestic or foreign consultants to do the job. Strengthening of project evaluation capability of the NEDA Secretariat at both national and regional levels and review of its evaluation standards, including the hurdle rate for an economic return considered acceptable, with the intention of revising them downwards, if found warranted, would obviously be helpful also. Aid programming, particularly

selection of projects for aid funding, would also be facilitated, if project evaluation could be confined to what is necessary for aid programming.

On the part of the creditor, further shift towards nonproject assistance seems to be justifiable in view of the massive capital surplus to be recycled partly through aid which is concretely manifested by its policy of a series of periodic doubling of aid, the latest for the five-year period 1988-1992. While the commercial element cannot be completely removed as an underlying motivation in aid-giving, its policy declaration of complete untying of the loan (except when used for procurement of consultancy services) leads one to believe that, at least in theory, the commercial motive is no longer predominant.⁷⁰ In practice, almost all contracts for OECF-assisted projects in the Philippines are still awarded to Japanese suppliers. In this regard, one aid observer pointed out that "in the eyes of some American policy makers the untying of (Japanese) loans has been in name only..." and that "there is a very strong perception in the U.S. that aid contracts are simply rigged behind the scenes so that when contracts are let whether or not a Japanese company will receive the business is a forgone conclusion."⁷¹ Be that as it may, the fact of the matter is that Japanese yen loan to the Philippines, except when used for consultancy is now generally untied which is consistent with Japan's avowed policy of reducing its huge trade surplus. If Japanese

70. Decision making with respect to allocation and form of aid lies largely in the hands of four ministries— Foreign Affairs, Finance, Planning and Trade and Industry (MITI). Since the constituency of MITI is in the Japanese business sector, MITI supports aid-tying and other restrictions designed to promote Japanese commercial interest. For explanation of Japanese aid decision making process, see Robert M. Orr, Jr., "The Politics of Japanese Foreign Aid," in Susan Pharr (ed.), *The Rise of Japan as a Major Aid Donor* (forthcoming). See also Reyes, *Official Development Assistance to the Philippines: A Study of Administrative Capacity and Performance*. For analysis of Japanese motives in Asia as a major aid source in a broad economic and political context, see Bruce Koppel and Michael Plummer, "Cooperation or Co-Prosperity? Asian Perspective on Japan's Ascendancy as an ODA Power" (Honolulu, Hawaii: East-West Center, 1989), mimeo.

71. Robert M. Orr, Jr., *The Aid Factor in U.S.-Japan Relations* (Temple University: Japan campus, July 1988), mimeo, p. 25.

suppliers still receive the business as they do in the Philippines and elsewhere thereby increasing rather than reducing Japan's trade surplus, it is no longer a consequence of aid-tying as an instrument of advancing its commercial objectives. If despite its declared policy of reducing its trade surplus, there is, in fact, still strong internal pressure to advance its commercial interests, tied-aid is no longer the instrument being used for that purpose at least in theory.

Based on the foregoing premise, the only justification to continue "projectizing" its yen loan available for investment financing would be to ensure that aid is used for specific investment with acceptable rate of economic return. But as argued earlier (see Chapter III) project tying may not even be an effective way of achieving that. Rather, a more effective way would be to link it to the entire investment program. The annual yen loan can therefore finance either a time slice or sectoral or sub-sectoral component of the program as a means of reducing the resource gap regardless of nature of cost and source of procurement.

As a direct measure to help reduce the trade gap, the remainder can be used, as before, for financing current imports including oil, regardless of the source of procurement, and for debt re-financing as in 1985.

United States: Aid Available for Investment Financing, Technical Assistance, Current Imports and Government Current Consumption

U.S. economic assistance to the Philippines falls under three accounts: (a) Development Assistance (DA); (b) Economic Support Fund (ESF); and (c) Food Aid. Before the change in government, part of DA was provided in loans. Like ESF, DA is now provided entirely in grants. Food aid under PL 480—Title I and

Section 416 of the U.S. Agricultural Act is provided in loans and under PL 480—Title II and Section 206 in grants.⁷²

In 1988, the U.S. pledged \$262 million broken down as follows: DA -\$38 million; ESF—\$174 million; and Food Aid—\$50 million, of which \$30 million was in loans under Section 416. The amount pledged under DA and food aid was committed (or obligated, which is the term used by the USAID Mission) through signed grant and loan agreement by September 30, 1988, the end of U.S. fiscal year. ESF, however, remained uncommitted as of December 31, 1988.

Under normal circumstances, aid appropriated by the U.S. Congress during a fiscal year must be committed (or obligated) during the same year. In the case of ESF appropriation for 1988, however, the Executive Branch was authorized to commit it within two years ending September 1989.

Of the amount of \$174 million in ESF, \$124 million is supposedly provided pursuant to the current Military Bases Agreement, while \$50 million is additional whose utilization is prescribed in the appropriation act of the U.S. Congress to support the Comprehensive Agrarian Reform Program (CARP). Since the purpose for which the latter will be used is specified by Congress, its programming did not prove as difficult as the former. The only major source of disagreement was how it will be used to support CARP.

One alternative was the usual procedure of linking disbursement to specific projects in CARP or in support of CARP which will be slow due to difficulties associated with projectizing aid. Moreover, direct cost of land transfer was declared ineligible for funding. Therefore, only projects *in support of* CARP rather than directly related to transfer of landownership would be eligible.

72. Florian A. Alburo and Romeo A. Reyes, "The Role of the United States in Promoting Development through Aid," paper presented to a seminar sponsored by East-West Center, Honolulu, 1988, p. 21.

Another alternative for which broad agreement had been reached and whose mechanics were under negotiation as of December 1988 was to use aid to support the entire CARP as a program and to link disbursement to agreed upon indicators of program performance, e.g., number of Land Transfer Certificates issued. The timing and the amount of the first tranche to be released or disbursed were major negotiation points. Naturally, the Philippines wanted the maximum amount to be disbursed upon signing of the covering grant agreement. Specific output rather than input-oriented performance indicators and extent of performance as a precondition for periodic disbursement were the other major negotiation points. Before U.S. FY 1988 ended in September, there was indication from the USAID mission that another \$50 million in ESF money might be available in FY 1989 if the previous \$50 million, which had become available in early 1988, would be easily absorbed in 1988 and early 1989. As it turned out, it was not even committed by the end of U.S. FY 1988 nor by the start of CY 1989. Delay in actual inflow of \$50 million pledged in 1988 and abortion of another \$50 million potentially available in 1989 based on USAID mission representation was particularly costly considering that dollar proceeds from this type of aid constitute free foreign exchange which can be used for any external transaction while peso proceeds may be used for any kind of budgetary outlay, including current operating expenditures, whether for agrarian reform or for any other program.

Programming of \$124 million under regular ESF proved to be even more difficult due to disagreement within the Philippine aid administrative system, in the first instance, and between the Philippine government and the U.S. government. Unlike the previous amount which must be utilized to support a specific program of the recipient government, this amount is available for a wider range of alternative uses. As indicated earlier in Chapter IV, ESF money had previously been programmed for financing specific investment projects, technical

assistance in project design and supervision, local currency cost of other foreign-assisted projects and even for current operating expenditures in the budget. Except for a minor proportion earmarked for foreign consultancy, ESF has been the principal source of aid in the form of free foreign exchange which does not entail subsequent outflow due to debt service. As such, it is particularly attractive as a source of foreign exchange for supporting the Balance of Payments and as a source of nontax revenue for financing government expenditures in general.

Within the Philippine government, there was consensus to allocate most, if not all, of the amount for general budget support rather than for specific projects administered by the ESF Secretariat in the interest of timeliness in aid absorption. To cover additional funding needs of the ESF Secretariat, an amount of \$21 million was programmed from the DA account. (Aid under this account can only be used for specific investment or technical assistance projects.)

From USAID standpoint, aid is delivered either for project or nonproject assistance. When used for project assistance, individual project feasibility must be established and aid disbursement must be linked to progress of project implementation and corresponding cash requirement. Aid for budget support is a form of non-project assistance. While aid disbursement is not linked to progress of project implementation as aid is not intended to finance specific projects, USAID wanted to link it instead to conduct of a "policy dialogue" and to measures geared towards making more financial resources available to local government units. Furthermore, USAID's concept of using aid for budget support means that peso proceeds of aid will be used for financing current operating expenditures specified in the budget.

Since ESF money is viewed by the Philippines as rental payment, USAID's proposal which, in effect, imposes conditionalities for the use of ESF money was

considered unacceptable. The counterproposal was: (a) to use the amount of \$124 million for public investment support, i.e., to partly finance the rural infrastructure component of the public investment program whose expenditures are included in the CY 1988 budget duly approved by the Philippine Congress; (b) to delink disbursement of ESF from conduct of policy dialogue between the Philippines and the U.S. without prejudice to conducting one in a context outside of ESF disbursement; and (c) to link disbursement instead to the progress of implementation of the entire rural infrastructure component of the public investment program measured against agreed upon performance targets.

While USAID received the counterproposal with an open mind, it expressed doubts over the feasibility of monitoring and measuring progress of implementation of the public investment program, particularly the rural infrastructure component composed of hundreds, perhaps thousands, of small rural projects in roads, water supply, school buildings, etc. It was therefore agreed that an audit of the monitoring system be conducted to verify its existence, in the first place, and the reliability of information it generates as a basis for ESF disbursement. As CY 1988 ended, a draft of the audit report confirming existence of monitoring system and commenting on its features was being circulated.

While the position and counterproposal of the Philippine government was determined and agreed upon at the highest level and there was consensus to resist imposition of a "policy dialogue" as a conditionality, there were two opposing schools of thought with respect to the items of government expenditure for which peso proceeds from ESF will be used. One school advocated use of the proceeds for public investment in rural infrastructure and, therefore, for capital outlays and linking its release to progress of implementation as a "carrot and stick" for achieving a more satisfactory implementation of the public investment program which had seriously fallen behind targets for the past two years and, as a

consequence, adversely affected economic growth performance. The other school did not mind using peso proceeds from ESF for current operating outlays since it would allow immediate inflow of ESF money as demonstrated on two previous occasions when ESF was used for budget support. On those occasions, it was recalled that specific items of current expenditures were easily identified in the budget and readily accepted by USAID. As in 1987, the coverage and extent of implementation of policy and institutional reforms can be negotiated and agreed upon so that they are consistent with what the Philippine government would have done in any case. Further, funds from domestic sources liberated by using ESF money for current operating expenditures can then be used to finance capital outlays of the rural infrastructure program.

The point made earlier in this chapter regarding application of funds is worth repeating at this juncture. Because funds are fungible and because efficiency in total resource use, including aid, is what really matters to promote growth, the question of whether aid is used for capital or current outlays seems to be less important than whether aid is actually being used at all.

Translating Aid Commitments into Disbursements

Once aid is committed for specific purposes, including financing of specific projects for investment or for technical assistance, the final task would be to translate various commitments into disbursements so that aid is actually absorbed or it becomes part of total resources at the disposal of the recipient.

Regardless of the purpose for which aid is committed, there are conditions precedent to aid disbursement which must be met even after the instrument of commitment, i.e., a loan or grant agreement, had been signed. Typically, these conditions relate to availability of local resources to be contributed by the recipient, readiness of the recipient to undertake the project or the activity for

which aid will be used, and, in the case of loans, validity and legality of the covering documentation, all certified by a competent authority in the Philippine government. With respect to aid commitment in the form of loans, a standard condition precedent to disbursement is a certification from the Department of Justice that the loan document constitute a valid and legally binding obligation on the part of the Philippines.⁷³

For aid programmed in the form of nonproject assistance, meeting conditions precedent is relatively easier and immediately leads to rapid aid disbursement. For loans and grants whose disbursement is linked to performance in implementation of policy and institutional reforms, the first of a series of tranches (two or three) is typically released upon issuance of the required certification from the Department of Justice. This is possible since specific policy and institutional reforms together with periodic performance targets had typically been agreed upon even prior to signing of the loan or grant agreement. Subsequent tranches are then released upon implementation of agreed upon policy/institutional reforms measured against performance targets satisfactory to the donor/creditor.

For aid whose disbursement is linked to a sectoral investment or operation and maintenance program, e.g., in irrigation, aid disbursement is less immediate and less rapid since actual expenditure must be incurred first by the implementing agency which is then reimbursed fully or partially by the donor/creditor. Even after actual expenditure and disbursement of local currency has taken place, aid disbursement can be delayed due to the process of reimbursement and preparation

73. Romeo A. Reyes, *Official Development Assistance to the Philippines: A Study of Administrative Capacity and Performance*, p. 50.

of documents, including evidence of local currency disbursement, required by the process itself.

For aid whose disbursement is linked to commodity procurement, immediate and rapid disbursement can also take place if prior to the commitment there is agreement about the specific items of commodities, procurement procedures, international shipping and domestic handling arrangements, aid disbursement mode and the allocation of and procedure for using local currency proceeds. Otherwise, sorting out these matters in a way which is mutually acceptable to donor and recipient can delay aid disbursement.

For aid whose disbursement is linked to a project either for investment or for technical assistance and to the progress of its implementation, meeting conditions precedent to disbursement becomes more difficult. In many cases, these conditions include: establishment of a project management office; formation of a project management team; recruitment of project staff; certification of a covering appropriation for both aid proceeds and local counterpart contribution; and preparation of a detailed project implementation plan with adequate and objectively verifiable performance targets acceptable to the aid donor/recipient.

Once all conditions precedent to disbursement are met, actual aid absorption would depend on actual project implementation. To start with, the implementing agency must ensure that project expenditures, including those chargeable against aid proceeds are authorized by law through appropriation and programmed in the annual budget of income and expenditure. Thereafter, the agency must secure authority from the Department of Budget and Management to obligate the funds, including those from aid and regardless of whether aid will be disbursed or paid directly to suppliers. Where aid is disbursed through reimbursement of actual expenditures by the implementing agency, the agency must obtain release of cash in local currency from time to time. To justify the amount and timing of release,

the agency must prepare and submit a quarterly work and financial plan for the project to the Department of Budget and Management. To effect initial and subsequent progress and final payment to suppliers, it had to be pre-audited by the Commission on Audit. Finally, to effect reimbursement of payment to suppliers so that aid is disbursed, the agency must present evidence of payment, among other documents. Upon satisfactory review of required documents by the donor/creditor, then, and only then, will part of aid be eventually disbursed and remitted to the account of the recipient.

To be able to implement a project and to absorb aid for that purpose, the implementing/recipient agency must have the organization and manpower. With respect to the latter, project personnel must be competent both on the technical as well as financial aspects of project management which is acquired mostly through experience rather than formal training.

The reorganization of the bureaucracy and the extensive substitution of its personnel at all levels referred to earlier which had adversely affected project identification and preparation capability also had similar effect with respect to project implementation/management and therefore aid absorption.

Delays in implementation of on-going projects and in start-up of newly approved/funded projects were encountered. As of June 30, 1987, implementation of 72 major on-going foreign-assisted projects were delayed by an average of 31 months compared to schedule. In many instances, start-up of project implementation was observed to take place only after six months to more than a year after loan/grant commitment.⁷⁴ As indicated earlier, disbursement of aid declined in 1987 after posting an initial increase in 1986, mainly as a

74. Project Facilitation Committee, *GOP Proposal for Project Development and Implementation*, February 1988 (mimeo), pp. 13 and 21.

consequence of delays in foreign-assisted projects to which most aid disbursement is linked.

Maintaining an image of clean government which the new political regime seeks to achieve partly through a policy of full transparency in government transactions and strict observance of control procedures designed to safeguard use of public funds tended to inhibit somewhat aid absorption performance.

Shortly after the change of government, the Commission on Audit (COA) reinstated the practice of pre-audit. All claims for payment relating to supply of goods or services for project implementation had to be reviewed by COA beforehand. Pre-audit included visits to project sites by auditors to undertake ocular inspection of project accomplishments reported to justify claims for payment. Further, COA review of contracts was necessary before they can be perfected and entered into by and between the contractor and project implementing agency. In certain cases, auditors wanted to review project feasibility studies prior to contract approval, blurring the distinction between management and auditing functions.

Conscious of the policy of strict observance of control procedures, implementing agencies had to familiarize themselves, in the first instance, with such procedures particularly those relating to procurement of goods and services and disbursement of funds from the standpoint of the Philippine government as recipient and from the standpoint of each donor/creditor. As exemplified in the Italian case cited earlier, implementing agencies were, at best, reluctant to take quick action even if it can be done without violating specific contracting procedures for fear that in doing so, a violation might be committed. Often, officials from implementing agencies were reluctant to make a decision or take action and assume full responsibility with respect to proposed transaction with

financial implications unless they are advised to proceed by another agency thereby giving them a sense of shared responsibility.

While the objective of safeguarding use of public funds, including aid proceeds, may be considered paramount and laudable, it should not be pursued in complete disregard of the important need for effectiveness and timeliness of their use. Concern with control in the use of public funds would still have to be properly balanced with the need for effective and timely delivery of public services. Management functions should continue to be separated and not be confused with auditing functions in the conduct of government. Safeguarding use of aid which was deemed inadequate or lacking in the past should not lead to undue delay, if not outright prevention, of its use.

Chapter VI

Expediting Aid Commitment and Disbursement

When the new government came to power in early 1986 and additional/new pledges of aid were made by traditional and new sources, the propriety of using aid through nonproject assistance was immediately recognized. For one, relevance and consistency of projects already in the pipeline and even those ongoing with the new development goals, strategy and priorities had to be reviewed. For another, a good portion of the capital stock from past investment both in the public and private sector was unutilized due to lack of resources for operation and maintenance or lack of demand for its output. Further and as earlier mentioned, there was a thin project pipeline due to the lull in project identification and preparation during the last two or three years of the previous regime. Furthermore, attempts at reviving the pace of project development activities with a view to committing and disbursing much larger amount of aid through project assistance encountered serious difficulties in the midst of reorganization of the bureaucracy.

To expedite aid commitment and disbursement, the government sought to the extent possible, nonproject assistance such as structural adjustment (policy-based) and sector loans from IBRD and ADB, commodity assistance from Japan, Canada, Australia and other bilateral sources and budget support from the United States.

Except for one or two loans from IBRD in the agriculture sector which were cancelled almost totally, all aid committed to projects continued to be available for disbursement. However, partly because of the new auditing procedures which considerably impinged into the function of management and of construction contracts left unacted upon at the Office of the President when the previous regime ended, disbursement of already committed aid could hardly continue.

Concerns on the build-up of aid "overhang," i.e., committed aid remaining undrawn, thus began to be expressed initially by ADB and IBRD and then by the bilaterals led by the United States.

Immediate measure taken by the government was to increase the amount of contract (up to P100 million or roughly \$5 million) which the heads of line departments can approve. Effectiveness of this measure, however, was neutralized by the introduction of pre-audit. While approval of the Office of the President for contract amounting to P100 million or below could now be dispensed with, it could not be perfected nor could payment be effected to contractors unless the contract was reviewed beforehand by COA and all claims for payment were pre-audited. Upon strong representation by project managers and other officials of line departments to lift pre-audit during a policy forum organized by the Development Academy of the Philippines in January 1987, the COA Chairman agreed to phase-out pre-audit subject to strengthening of agency internal control systems.⁷⁵ It was only in November 1987 when COA partially lifted pre-audit requirements and set time-frame for itself within which action should be taken in the performance of its audit function.⁷⁶ Notwithstanding partial lifting of pre-audit, the agency head would still need to secure approval of the auditor with respect to availability of funds and covering appropriation prior to signing of contract. After signing, approval of the contract itself by the Auditor would still be required although the implementing agency may proceed with project implementation. The most noteworthy improvement was the provision that only the last progress payment representing 15 percent of contract amount will be subject to pre-audit. A precondition for this, however, is completion of

75. Development Academy of the Philippines, *Proceedings of the Policy Forum* (January 23, 1987), p. 20.

76. COA Circular No. 87-278, November 12, 1987.

post-audit of previous progress payments representing 85 percent of contract amount.

The NEDA Secretariat also initiated actions intended to expedite aid commitment and disbursement. Pursuant to its function of monitoring project implementation and aid utilization in conjunction with aid programming, the Secretariat took the initiative of identifying and reporting to the Board projects suffering serious delays. Upon instruction of the Board, attention of implementing agencies was subsequently called and appropriate measures to address the delay were suggested.

To expedite the process of hiring consultants for feasibility studies, detailed engineering design and construction supervision and in line with the policy of decentralization, the NEDA Secretariat also initiated removal of its authority and responsibility to review consultancy contracts which was deemed outside of its planning and programming functions. Instead, implementing agencies were given full authority to approve all consultancy contracts subject to guidelines issued by the Board. In many instances, however, implementing agencies continued to refer draft consultancy contracts to the Secretariat for comments to validate whether they conform with the prescribed guidelines.

To rationalize aid programming for public investment financing and for technical assistance, the Secretariat prepared and the Board approved medium-term public investment and technical assistance programs, respectively. As indicated previously, however, rationalization of aid programming did not always lead to facilitation of aid use. To further rationalize programming of investment, including those to be partly financed by aid, and of technical assistance, the Secretariat has been attempting to formulate and hopefully install a comprehensive investment programming system (CIPS) which would link investment and technical assistance programming activities at the regional and

national levels. Finalization and installation of the system has been hampered by the difficulty and controversy surrounding the reconciliation of priorities established by each region among projects within and across sectors, on the one hand, and the priorities established by each implementing agency, e.g., Department of Agriculture, among projects within and across regions, on the other. To appreciate the source of difficulty and controversy, it should be noted that the Philippines has a unitary system of government with twelve administrative regions, three of which are "autonomous" or in the process of gaining autonomy, pursuing a decentralization policy within the national government (deconcentration) and from national to local government units (devolution).

The Department of Budget and Management, for its part, introduced flexibility in cash management initially at the Department of Public Works and Highways to help accelerate project implementation through establishment of a Common Fund.⁷⁷ Under this scheme, fast-moving projects can use cash earmarked for other projects which are slow-moving provided that they are clustered under the same Common Fund. After testing the new scheme at the Department of Public Works and Highways, it was subsequently applied to all other line departments and offices of the national government.⁷⁸ The Common Fund was adopted in response to the claim of project managers that one reason for delay in project implementation was unavailability of funds to some projects in the face of huge bank balances in others.

77. Department of Budget and Management, Circular Letter No. 87-7, October 1, 1987.

78. Department of Budget and Management, National Budget Circular No. 398, June 14, 1988.

Notwithstanding the foregoing measures, commitment and disbursement of aid against increasing aid pledges continued to be viewed as unsatisfactory by the donor community and even within the Philippine government. Towards the end of 1987, both local and international media carried news items about billions of "unused aid."⁷⁹ Senior officials from multilateral sources and ambassadors from bilateral sources conveyed to their counterparts in the Philippine government and on some occasions, to the Office of the President their concerns over delay in disbursement of committed aid and delay in programming and commitment of new aid pledges. These concerns were heightened as initiative towards a possible "Mini-Marshall" plan for the Philippines was taken in November 1987 by a group of legislators from the U.S. Congress. The plan envisions mobilization of \$5 to \$10 billion additional aid from the United States, Japan and other bilateral and multilateral sources for the period 1988-1992. As steps were taken towards realization of this aid initiative, the donors/creditors raised a valid question. If the Philippines could not fully absorb existing aid pledges of around \$3 billion in 1987 and annually thereafter under their regular aid programs, could it justify annual absorption of an additional \$1 or \$2 billion under the "Mini-Marshall" plan?

Recalling that aid delivery in the past had predominantly been through project assistance and realizing that, unless the donors are persuaded otherwise, it will continue to be so in the future, the Philippine government squarely addressed the issue of aid absorptive capacity when it organized a Project Facilitation

79. *The New York Times* quoted \$1.5 billion in "unused aid" as of September 30, 1987, as reported by the Philippine Embassy in Washington. Based on NEDA data files, \$4.5 billion was committed, of which \$3.4 billion was scheduled for disbursement. Since only \$2.0 billion was actually disbursed, there was a delay in inflow of \$1.4 billion.

Committee (PFC) chaired by a Presidential Adviser with cabinet-rank whose functions are to

"catalyze actions, identify and unclog bottlenecks both at policy and procedural levels and monitor results of the thrust of the government to intensify its efforts for the preparation, prioritization, selection and implementation of projects."⁸⁰

In conjunction with the creation of PFC, the President directed all heads of department and government corporations to appoint a Project Implementing Officer who would be responsible for overseeing the intensification of project development and implementation efforts at their respective offices. The most significant actions taken by the PFC were: (a) identification and facilitation of resolution of issues causing bottlenecks in project operation at central policy, implementing agency, and project management levels; (b) obtaining commitment from agencies to set performance targets both in project preparation and project implementation; and (c) closely monitoring actual performance against verifiable targets through regular quarterly visits to implementing agencies and dialogue with Project Implementing Officers to jointly identify corrective actions, if found necessary and (d) facilitation of implementation of corrective actions, particularly at the central policy level.⁸¹

As a consequence of the above measures, including creation of the PFC, improvement in ODA loan disbursement and in project development in 1988 relative to 1987 was reflected by several indicators. With respect to the former, cumulative loan availment rate for foreign-assisted projects i.e., cumulative ratio of actual to scheduled loan disbursement, steadily increased from 71 percent, in December 1987 to 72 percent, 73 percent and 77 percent as of March, June and

80. Office of the President of the Philippines, Memorandum Order No. 131 Creating a Project Facilitation Committee under the Office of the President, November 18, 1987.

81. Project Facilitation Committee, GOP Proposal for Project Development and Implementation, February 1988 (mimeo).

September 1988, respectively. On the project development side, the NEDA Secretariat managed to evaluate and endorse to prospective donors/creditors 346 project proposals mostly for technical assistance from January to September 1988, compared to only 87 for the entire year of 1987. It should be noted, however, that 169 or more than a half of proposals endorsed were under "automatic endorsement" as per instruction of the NEDA Board mentioned earlier. The Investment Coordination Committee also registered a better performance in terms of number of projects approved for implementation from 16 (valued at P27.3 billion) from January to September 1987 to 27 (valued at P39.5 billion) for the same period in 1988. More impressive performance was registered by the aid administrative system as a whole in terms of number of projects for which loan agreement was signed with creditors from only five (with a loan value of \$0.67 billion) from January to September 1987 to 29 (with a loan value of \$1.5 billion) for the same period in 1988. Notwithstanding these considerable improvements, particularly in aid programming—a crucial step in the process of aid absorption—the donor community and a number of implementing agencies and prospective aid recipients within the Philippine government continued to have doubts over the capability of the existing aid administrative machinery built around the NEDA system (NEDA Board, Investment Coordination Committee, Secretariat) as provided by law to handle the coordination of mobilization, programming, and overall management of anticipated bigger amounts of aid forthcoming under the Philippine Aid Plan.

In response, a Presidential task force on the Philippine Aid Plan (TF-PAP) chaired by the Executive Secretary and composed of representatives from executive and legislative branches of government and from the private sector was established for the specific purpose of administering mobilization, allocation, programming and use of aid expected to be forthcoming under the PAP. It was

backstopped by a technical committee whose chairman was drawn from the Department of Finance. While the Secretary of Economic Planning who is head of the NEDA Secretariat was included as a member of the task force and a senior official (rank of undersecretary) of the NEDA Secretariat as a member of its technical committee, the formation of the task force in June 1988 was a clear signal that the NEDA Board's authority partially delegated and function fully delegated to its Secretariat relating to programming of aid forthcoming under PAP was being withdrawn and transferred to another entity. The choice of officials chairing the task force and the technical committee was also a signal that the Office of the President and the Department of Finance would now have a larger role and stronger influence in the decision making process with respect to aid allocation and programming, at least with respect to aid forthcoming under the PAP. However, delegated function could not be practically transferred to the new entity as easily nor as promptly as delegated power.

The TF-PAP had to rely substantially on the technical inputs from the NEDA Secretariat in carrying out its task because neither the Office of the President nor the Department of Finance had adequate staff to provide the necessary technical backstopping to the TF-PAP.

As prospects of higher levels of aid available for commitment under the PAP became clearer and brighter, a Coordinating Council on the Philippine Aid Plan (CC-PAP) was formed in lieu of the TF-PAP and a full-time chairman was appointed in March 1989. Since the underlying premise was that aid forthcoming under PAP would be over and above what would have been forthcoming without PAP, the NEDA Secretariat acquired the impression that programming of aid outside PAP delegated to it by the Board will continue to be its responsibility. As in the case of TF-PAP, CC-PAP also had to rely at least initially on the technical support of the NEDA Secretariat so that the task was, in effect, being carried out

mostly by the Secretariat. As before, while delegated power was apparently withdrawn and transferred to a new entity, delegated function had to remain, at least partially, at the NEDA Secretariat for the time being.

After the formation of CC-PAP, it turned out that there would not be any more distinction between aid made available under PAP and outside PAP, as donors/creditors could not really make a determination whether aid pledged in 1989, for example, would have been pledged with or without PAP. Even if distinction is possible, donors/creditors would normally prefer programming of their aid as one integral package rather than in two parts and dealing with one entity rather than two, one for aid under PAP and another outside PAP, if only to save on administrative burden.

The choice between using the NEDA Secretariat and the CC-PAP in carrying out total aid programming function, inclusive of PAP, thus became inevitable. It had to be one or the other. If it is the latter and it absorbs the function of the former relating to aid programming, it would be logical for it to also absorb the personnel who have gained experience and expertise in carrying out the function. It would remove the need to hire and train new people in the bureaucracy who will now carry out the function and to fire existing staff of NEDA who lost the function. But under the new organizational structure of NEDA and in line with the policy of decentralization (see Chapter V), the entire NEDA staff, including those in the NEDA regional offices, are involved in aid programming, especially with respect to project evaluation. Thus, CC-PAP absorption of NEDA Secretariat's function and personnel relating to aid programming would be, in a sense, tantamount to absorption of the broader resource programming function of the Secretariat and practically all of its personnel. Besides, if NEDA should completely lose its aid programming function, its ability to influence allocation of

resources especially capital, which is so crucial in carrying out its mandate of development management, would be severely impaired.

In the midst of preparations for the Pledging Conference for PAP on July 3-5, 1989, the Secretary of Economic Planning resigned over the issue of responsibility for aid programming. Shortly before the Pledging Conference, a new Committee on ODA (CODA) was constituted within the NEDA system through Administrative Order 128. The committee is chaired by the chairman of the CC-PAP. Unlike other NEDA board committees where the NEDA Director-General is either chairman or co-chairman, she/he is only a member of CODA. This administrative action, in effect, withdrew from the Investment Coordination Committee and from the Secretariat whatever power and function relating to aid programming were previously delegated to them by the board and transferred the same to CODA. As indicated earlier, the power and function of aid programming are vested in the NEDA board by law through Executive Order No. 230 and could be administratively delegated without inviting potential legal questions only to its Secretariat and/or to any of the committees constituting the NEDA system. As an entity within the NEDA system, CODA could rely on and make use of the NEDA Secretariat in exercising the power and performing the function relating to aid programming delegated by the NEDA board and thereby avert possible disintegration of the NEDA Secretariat as an organization. A potential legal issue, however, is whether the President or Congress has authority to create additional committees within the NEDA system in addition to those prescribed in E.O. 230 reorganizing NEDA. Examination of E.O. 230 reveals that authority of the President to exercise administrative discretion with respect to the structure of the NEDA system seems to be confined to changes in membership of the board and designation of acting chairman of the board in her absence.

Chapter VII

The Future: How Much Aid Is Required, Available and Manageable

Based on the premise that foreign aid is necessary to reduce or close a foreign exchange or external financing gap to attain economic growth targets, estimation of foreign aid requirement proceeds from projection of outflows and inflows of foreign exchange required to attain such targets.

For the current plan period 1988-1992, an average annual growth of 6.5 percent in real GNP is targeted (see Table VII-1). To attain this, agriculture, representing 28 percent of GNP in 1987 is targeted to grow at 3.5 percent annually and industry, representing 32 percent, at 9.1 percent. On the demand side, consumption is projected to grow annually at 5 percent and investment at 19 percent. The target growth of investment and GNP implies an average investment rate of 21 percent, rising from 14.6 percent in 1987 to 23.6 percent by 1992 and an investment efficiency in terms of ICOR of around 3.3. Since the average national savings rate is projected to lag behind domestic investment rate, foreign savings will continue to be relied upon to close the resource gap representing 2.5 percent of GNP, on the average, for the current plan period.

In 1988, real GNP growth was registered at 6.7 percent, exceeding the target of 6.4 percent. For the first quarter of 1989, however, real growth was recorded at 4.8 percent, suggesting that the target for the entire year and for the rest of the plan period may not be attainable as the major source of growth shifts from increased consumption with low investment rate made possible by utilization of idle capacity to substantial increases in investment as existing capacity becomes more fully utilized. In 1986, investment rate was only 12.9 percent, slightly rising to 15.6 percent in 1987 and 17.1 percent in 1988 (see Table IV-1). To sustain GNP growth at the 6 percent to 6.5 percent range in 1989 and thereafter, the

investment rate is projected to rise to 19.9 percent in 1989 and further to 23.6 percent by 1992. Those rates of capital absorption may be considered attainable when compared to almost 30 percent in 1975-80 yielding an average annual GNP growth of 6.2 percent with an ICOR of 4 and to 24.5 percent in 1980-85 when investment efficiency was much lower.

TABLE VII-I Philippines: Selected Macro-Economic Targets (In millions of U.S. dollars)							
	1987 (Actual)	1988	1989	1990	1991	1992	1988-1992
Investment (% to GNP)	14.6	17.3	19.9	21.5	22.5	23.6	21.0*
National Savings (% to GNP)	14.6	15.5	17.3	18.6	19.6	21.1	18.5*
I - S = Foreign Savings (% to GNP)	.0	1.8	2.6	2.9	2.9	2.5	2.5*
Current Account Balance	-539.0	-677.0	-1096.0	-1297.0	-1407.0	-1342.0	-5819.0**
Overall GOP ¹	-1758.0	-1849.0	-2491.0	-2641.0	-3035.0	-2524.0	-12540.0**
External Debt	28.6	28.8	30.8	32.1	33.5	34.8	
GNP Real Growth (In %)	5.7	6.4	6.7	6.5	6.3	6.5	6.5*
Deb/GNP Ratio (In %)	83.4	75.7	73.1	71.3	68.8	64.6	
Debt Service Ratio (In %)							
To Imports of Goods and Services	32.2	31.0	28.9	29.5	30.3	25.7	
To Current Account Receipts	31.3	29.2	27.3	27.9	28.7	24.4	
¹ Before rescheduling of debt and new money.							
* Annual Average for 1988-92							
** Total for 1988-92							
Source: Republic of the Philippines, NEDA, Updates on the Medium-Term Philippine Development Plan, 1988-1992, July 1988.							

In view of continuing reliance on foreign savings to partly finance domestic investment, and an average annual import growth of 9.5 percent outpacing that of exports, an average annual deficit of over \$1 billion in the current account is projected, bringing a total of \$5.8 billion for the entire plan period under the

TABLE VII-2							
Philippines: External Financing Requirements (In millions of U.S. dollars)							
	1988	1989	1990	1991	1992	1988-92	1989-92
Trade Balance	-1054	-1520	-1770	-1670	-1530	-7544	-6490
Exports	7074	8040	9005	10350	11895	46364	39290
Imports	8128	9560	10775	12020	13425	53908	45780
Non-Merchandise Trade (Net)	39	-152	-298	-509	-767	-1687	-1726
Inflow	3606	4078	4298	4555	4741	21278	17672
of which: ESF	24	172	172	186	84	638	614
Outflow	3567	4230	4596	5064	5508	22965	19398
of which: Interest Payments ¹	2041	2402	2527	2732	2872	12574	10533
Transfers (Net)	789	865	979	987	1065	4685	3896
Inflows	791	869	984	992	1070	4706	3915
of which: Grants ²	175	187	234	159	139	894	719
Outflows	2	4	5	5	5	21	19
Medium- and Long-Term Loans (Net)	97	330	-73	-664	-657	-967	-1064
Inflows ³	1032	1279	1081	820	504	4723	3684
Outflows ⁴	942	949	1154	1484	1161	5690	4748
Direct Investments	986	880	850	850	875	4441	3455
Inflows	1077	987	977	967	987	4995	3918
Outflows	91	107	127	117	112	554	463
Short-Term Capital and Others	-857	-2065	-848	-1068	-573	-5411	-4554
Inflows ⁵	358	345	380	420	460	1963	1605
Outflows ⁶	1215	2410	1228	1488	1033	7374	6159
External Financing Requirements	0	-1662	-1160	-2074	-1587	-6483	-6483
Total Inflows	13945	15598	16725	18104	19657	84029	70084
Total Outflows	13945	17260	17885	20178	21244	90512	76567
¹ Net of rescheduled interest payments due Paris Club totalling \$484M for 1989-92.							
² From US (\$190M), Multilateral Agreements (\$6M) and bilateral agreement with other countries (\$523M).							
³ Includes MLT nonmonetary loans (\$551M), identified new money (\$2208M) and IMF drawings (\$925M).							
⁴ Includes amortization on existing nonmonetary and monetary loans. (MLT loans net of rescheduling, errors and omissions, BOP revaluation adjustment).							
⁵ Includes net nonmonetary short-term loans, monetization of gold (\$1605M), and interest rebate.							

⁶Includes nonmonetary short-term loan payments (\$216M); monetary short-term loan payment (\$786M), reserve build-up (\$3190M); and loans converted into equity (\$2122M) and revaluation adjustment (-\$155M). The targeted reserve build-up for 1988-92 are as follows:

1988	2059	2.1
1989	3485	3.0
1990	3875	3.0
1991	4299	3.0
1992	4756	3.0

NOTE: Details may not add up to total due to rounding.

The external financing requirements were computed based on CB-BOP Projections (Model D) as of March 5, 1989. The BOP projections incorporated the terms of the Second Round Restructuring Agreements with the commercial banks and Paris Club. The BOP projections further assumed restructuring of obligations to the Paris Club falling due in the second half of 1988 until 1992. The restructuring terms are as follows:

- a) restructuring of principal obligations to commercial banks falling due in 1983-86 (previously restructured) and in 1987-92; and restructuring of 100 percent principal and 70 percent interest obligations to Paris Club creditors falling due in 1987-92.
- b) maturity period of 17 years including 7 1/2 years grace period and margin of 7/8 of 1 percent over LIBOR for bank restructured debts; maturity period of 10 years including 5 years grace period for Paris Club debts.
- c) reduction of the margin for credits covered by the New Money Agreement and Trade Facility of 7/8 and 3/4 of 1 percent over LIBOR respectively.
- d) extension of trade facility through June 1991.

current 5-year development plan. Without any rescheduling of debt service and new money, overall BOP is projected with a bigger deficit of \$12.5 billion, implying a deficit in both current and capital accounts and continuous drawdown on reserves. Considering that international reserves as of December 1987 was only \$2 billion, equivalent to 2.3 months of imports, and that the target level of reserves from 1989 onwards is equivalent to 3 months of imports, further rescheduling of existing debt service or other forms of debt relief and inflow of new money would be necessary if the growth target for the plan period is to be achieved.

Using more recent BOP projections of the Central Bank as of March 5, 1989, making provisions for international reserves build-up so that it represents the equivalent of three months of imports beginning in 1989 and taking into account all identified new money, including the latest IMF credit of \$925 million, and the terms of all debt restructuring agreements with the banks and governments under the Paris Club, the NEDA Secretariat is now projecting a lower external financing or "new money" gap of \$6.5 billion for the plan period (1988-1992) which must be filled to attain real GNP growth target (see Table VII-2). This projection of external financing gap averaging \$1.6 billion a year already took into account all

identifiable sources of foreign exchange inflow, including those coming from known pledges of aid both in grants and concessional loans, identified new money, IMF drawings, gold monetization, etc.

Under the current account, a merchandise and nonmerchandise trade deficit of \$7.5 billion and \$1.7 billion are projected, thereby yielding an X-M deficit of \$9.2 billion. Since a net inflow of transfers amounting to \$4.7 billion is foreseen, the projected deficit in the current account is reduced to \$4.5 billion, which is lower than the projected deficit of \$5.8 billion under the updated Philippine Development Plan.

Under the capital account, a net outflow of MLT loans of almost \$1 billion is still foreseen notwithstanding rescheduling of debt service and new money. It should be mentioned, in this regard, that debt service for loans from multilateral financial institutions are not negotiable for purposes of rescheduling. After making provisions for reserve build-up of about \$3 billion and retirement of loans converted into equity of \$2 billion, a huge net outflow in short-term loans amounting to \$5.4 billion is also foreseen. Thus, the only source of net inflow in the capital account would be a direct investment amounting to \$4.4 billion, which approximates the current account deficit for the plan period. Partly due to the program on debt/equity swap and overall improvement in confidence of foreign investors after the change in government, net direct investment is projected to play a much bigger role in financing the current account deficit and meeting other external financing needs.

Considering all identifiable inflows and outflows both in the current and capital accounts, an external financing gap of \$6.5 billion from 1989 to 1992 would have to be filled in light of a GNP growth target of 6.5 percent, consumption growth of 5.0 percent and investment growth of 19 percent. On the assumption that no further net foreign investment and new money (or debt

reduction) from commercial sources are forthcoming and no further improvement in the country's capacity to export is possible, the external financing gap would have to be filled by additional aid inflows for the remainder of the plan period (1989-1992), on top of aid flows coming from commitments already made or foreseen as of March 1989. Additional aid inflows required, therefore, would amount to an average of \$1.6 billion annually. In 1988, figures compiled by the NEDA Secretariat indicate actual inflow from ODA grants and loans amounting to only \$1.08 billion (see Table IV-6). In the projection of external financing requirements and net resource transfer, also made by the NEDA Secretariat, aid inflow reflected for 1988 amounts to about \$950 million in loans and \$200 million in grants (including ESF) or a combined total of \$1.15 billion (see Table VII-3). For 1989-1992, the Secretariat is projecting \$2.759 billion in loans and \$1.333 billion in grants (including ESF) or a total of \$4.092 billion aid inflow from commitments already made or foreseen as of March 1989. This translates into around \$1 billion annually (\$1.023 billion). This disbursement level may be considered realistic when compared to past disbursement performance. Total aid inflows *required* to achieve GNP growth target would therefore be around \$2.6 billion annually⁸² for the rest of the plan period, of which \$1.0 billion is expected from aid commitments made or foreseen as of March 1989, and \$1.6 billion represents additional requirement.

82. The required annual external resource inflow reflected in "The Philippines Agenda for Sustained Growth and Development," dated May 30, 1989, prepared by the government for the PAP Pledging Conference, to which the author gained access in August 1989, is \$2.774 billion. The total requirement for 1989-1992 was estimated at \$11.096 billion, broken down as follows: (a) grants - \$0.724 billion; (b) ESF - \$0.614 billion; (c) pipeline loans - \$0.551 billion; (d) inflows from loans committed January 1, 1986, to February 29, 1989 - \$2.208 billion; (e) inflows from loan commitments to be made starting March 1, 1989, based on known pledges - \$3.669 billion; and (f) additional required inflow - \$3.330 billion.

TABLE VII-3 Philippines: Projected Aid Inflow (Disbursements), 1989-1992 (In millions of U.S. dollars)						
	1988 (Actual)	1989	1990	1991	1992	TOTAL 1989-1992
Grants	175	187	234	159	139	719
ESF	24	172	172	186	84	614
Loans	948	1019	818	553	369	2759
New (Identified)	689	732	666	491	319	2208
Pipeline	259	287	152	62	50	551
TOTAL	1147	1378	1224	898	592	4092
Source: NEDA, Public Investment Staff						

To make this rate of aid inflow possible, a higher level of accumulated commitment would be necessary unless the share of nonproject assistance to the total aid portfolio is dramatically increased. As of March 1989, the share of nonproject loans to total loan commitment of \$5.8 billion is computed at 20 percent.⁸³ As of end of 1987, IBRD reported that the Philippines had an outstanding but undrawn loan commitment (referred to as "pipeline") of \$3.56 billion, against which a disbursement of \$870 million in 1987 was made.⁸⁴ This means that under a given loan portfolio in 1987, the Philippines could only disburse 20 percent of outstanding but undrawn loan commitment. Based on this ratio, outstanding but undrawn loan commitment or "pipeline" would have to be at a level of \$13 billion (which does not seem plausible) to allow disbursement and inflow of \$2.6 billion annually. The highest rate recorded was in 1983 at almost 25 percent. At that ratio, outstanding commitment would have to be around \$10.4 billion.

The World Bank is projecting a lower average annual growth of GNP at 5.7 percent for 1989-1992 which comes closer to the 1989 first quarter actual growth

83. NEDA, Status of ODA Loans as of March 31, 1989.

84. World Bank, *Toward Sustaining Economic Recovery, Country Economic Memorandum: Philippines*, Report No. 7438-PHI, January 1989, p. 52.

of 4.8 percent. Comparison between IBRD and official government projection is shown in Table VII-4.

TABLE VII-4			
Comparison Between IBRD and Philippine Macro-Economic Projections, 1989-1992			
	IBRD¹	Government of the Philippines²	
Real Growth Rates (in %)			
GNP	5.7	6.5	
GDP	5.7	6.4	
Agriculture	3.5	3.5	
Industry	8.0	9.1	
Services	5.0	6.0	
Private Consumption	4.2	4.6	
Government Consumption	4.0	7.9	
Investment	13.6	19.0	
Exports of G & NFS	7.6	9.0	
Imports of G & NFS	8.6	9.5	
Shares of GNP (in %)			
Investment	21.3	21.9	
Savings	18.2	19.1	
Current Account	3.1	2.7	
ICOR (Based on Fixed Investment)	3.3	3.3	
Current Account Balance	-2262	-5142	-4320*
Direct Investment (Net)	2427		4441*
Net MLT Loans	1457		-1064*
New Money Gap	4676	8100	6483*
Debt/GNP Ratio by 1992	57.1	64.6	
Debt Service/Exports Ratio by 1992	22.9	24.4	
Official Reserve Level by 1992	4658	4368	
Equivalent Months of Imports	3	3	
¹ Source: Report No. 7438-PH, page 43.			
² Source: NEDA Updated Philippine Development Plan and Projections of NEDA Secretariat.			
*Based on recent projection of NEDA Secretariat and Central Bank as of March 1989.			

In terms of growth from both the supply and demand side, it will be noted that IBRD is projecting more conservatively, except for agriculture at 3.5 percent which is the same as the target in the updated plan. On the demand side, the most significant difference between the two sets of growth projection is that of investment (13.6 percent by the Bank and 19 percent by the government.) However, the projected rate of capital absorption (investment rate) and

investment efficiency (ICOR) remain practically the same compared with each other due to the Bank's correspondingly lower GNP growth target. Under both projections, investment rate is 21 percent and ICOR is 3.3. The Bank's projection of current account deficit of \$2.3 billion for 1989-92 is also considerably lower than what is reflected in the government's updated plan (\$5.1 billion) and in the NEDA Secretariat's latest projection of external financing gap (\$4.3 billion). In the capital account, the Bank is much more optimistic with respect to MLT loans as it foresees a net inflow but less optimistic than the government on direct foreign investment. With respect to official aid flows, the Bank assumes an improvement in disbursement to about \$1.3 to \$1.4 billion annually for 1989-1992 over its estimate of \$1.2 billion in 1988.

With a more conservative GNP growth target of 5.7 percent, the Bank is projecting a lower external financing or "new money" gap of \$4.7 billion for 1989-1992 or an annual average of \$1.2 billion. Assuming that this gap can only be filled by new money coming from official sources, additional aid inflow requirement would be \$1.2 billion annually which is lower than what is required to fill the gap of \$1.6 billion projected by the NEDA Secretariat. The lower new money gap projection by the Bank is made possible by a lower current account deficit and the Bank's more optimistic projection of a positive net capital inflow. In turn, both are partly due to the Bank's slightly higher reading of aid disbursement in the past (\$1.2 billion in 1988) and its assumption of improvement in disbursement performance to \$1.3-1.4 billion for the next four years. Higher disbursement of grant from outstanding aid commitment would reduce the current account deficit. Higher disbursement of official loans, on the other hand, would improve net MLT inflow. With a financing gap of \$1.2 billion annually based on an assumed disbursement level of \$1.3 to \$1.4 billion from aid already committed and foreseen as of March 1989, total annual aid inflow requirement for

1989-1992 would also come to \$2.5 to \$2.6 billion, almost the same as the estimated requirement based on a higher growth target of the government and on the estimate of external financing gap by the NEDA Secretariat. These projections assume an investment efficiency in terms of ICOR of 3.3. At lower investment efficiency (3.7), IBRD is projecting a higher investment rate of 25 percent and a much bigger financing gap of \$7.3 billion or \$1.8 billion annually. Total aid inflow requirement would therefore be \$3.2 billion annually to attain 5.7 percent growth of GNP. If new money does not come and the gap is not filled, investment will have to be reduced and the Bank is projecting that growth would fall to 3.1 percent.

Let us now examine in greater detail whether the amount of aid required which is almost the same under alternative growth assumptions of 5.7 percent and 6.5 percent would be available and committed so that it could eventually be availed of or absorbed.

From 1978 to 1981, average annual aid commitment was recorded at \$1.02 billion. It increased slightly to \$1.04 billion from 1982 to 1985. In 1986, aid commitment increased to \$1.5 billion. This amount was maintained in 1987 before it increased substantially to \$2.2 billion in 1988. For the period 1989-1992, the NEDA Secretariat is projecting total commitment of \$11.6 billion or an annual average of \$2.9 billion in newly available and committed aid based on pledges which have been made or expected to be made as of March 1989. Table VII-5 presents the breakdown of projected aid commitment by source.

It should be noted that the above projection does not include additional aid which is expected to be mobilized under the Philippine Aid Plan (PAP). For CY 1989, projected commitment from pledges expected to be made was \$2.7 billion, even without the PAP, \$.5 billion higher than actual commitment recorded in the previous year. Of this amount, \$2.3 billion or 85 percent is expected from the

TABLE VII-5: Philippines: Projected* Levels of Available (New) Aid, 1989-1992 (In millions of U.S. dollars)						
	Actual Commitment 1988	1989	1990	1991	1992	TOTAL 1989-1992
Multilaterals	917.0	1165.8	1697.5	1395.0	1394.0	5652.3
ADB	384.0	558.0	978.0	737.0	738.0	
IBRD	506.0	600.0	712.0	656.0	656.0	
UN System	9.0	7.8	7.5	2.0	-	
Others	17.0	-	-	-	-	
Bilaterals	1319.0	1565.3	1464.6	1544.6	1408.6	5983.1
Japan	881.0	904.0	984.0	1064.0	1144.0	
U.S.	88.0	270.0	306.0	306.0	90.0	
Canada	20.0	16.5	15.4	15.4	15.4	
FRG	39.0	40.3	28.0	28.0	28.0	
Italy	90.0	134.8	90.0	90.0	90.0	
Netherlands	15.0	25.0	25.0	25.0	25.0	
France	43.0	53.0	-	-	-	
Spain	75.0	85.0	-	-	-	
Belgium	8.0	-	-	-	-	
Denmark	-	15.5	-	-	-	
Australia	16.0	16.0	16.0	16.0	16.0	
New Zealand	3.0	0.2	0.2	0.2	0.2	
U.K.	1.0	-	-	-	-	
Singapore	-	5.0	-	-	-	
Switzerland	40.0	-	-	-	-	
TOTAL	2236.0	2731.1	3162.1	2939.6	2802.6	11635.4
*Based on data available as of March 1989.						
Source: NEDA, Public Investment Staff.						

traditional "big four" sources, led by Japan with around \$900 million or about one third of the total. During the pledging conference in Tokyo on July 4-6, 1989, an amount of \$3.5 billion was reportedly pledged. Thus, \$800 million may be considered as additional aid pledges under the PAP. Japan, which is expected to be the principal source of additional aid under PAP,

"would commit \$100 million for development projects in the Philippines this year, over and above the roughly \$900 million in grants and loan already promised."⁸⁵

85. Thomas L. Friedman, "Baker Says U.S. Seeks \$1 Billion in Economic Aid to the Philippines," *The New York Times* July 5, 1989, p. A3.

While this amount additionally pledged by Japan would bring its total pledge for 1989 to \$1 billion, it represents only 12.5 percent of whatever additional pledges were made by 19 nations and 7 international financial institutions which participated in the conference. In addition, it should be noted that Japan's pledge for additional aid was specified for development projects which, as previously explained, will take more time to commit and disburse.

In the case of the U.S., the pledge was that "the Bush Administration would seek \$1 billion over the next five years in *supplemental* economic assistance...."⁸⁶ Since the U.S. Congress had already appropriated U.S. aid to the Philippines for 1989, appropriation of supplemental assistance to be sought by the Bush Administration could only begin in 1990. Prior to the pledge made during the conference, the Administration had reportedly asked Congress for \$281 million in economic assistance to the Philippines for 1990. How much of supplemental aid pledged by Mr. Baker would be appropriated by Congress in 1990 is not yet known although the Administration will reportedly ask for \$200 million.

It will be recalled that to attain the 6.5 percent GNP growth target, an additional aid inflow of \$1.6 billion annually would be required. Taking into account \$1 billion expected to be disbursed from aid commitments made and foreseen as of March 1989, total aid inflow required would be \$2.6 billion. At 5.7 percent growth projected by the Bank, additional aid inflow required is less at \$1.2 billion partly because of its optimistic projection of the country's ability to disburse existing and foreseen aid commitments. Total aid inflow required for the rest of the plan period would also be \$2.6 billion.

Even without PAP, around \$2.9 billion is expected to be committed annually, on the average. For 1989, \$2.7 billion is expected to be committed even without

86. *Ibid.*

PAP and \$3.5 billion with PAP based on pledges made in Tokyo. Thus, if expected commitment of aid pledged before and during the Tokyo conference would be realized in 1989 and at least maintained thereafter, and yearly commitment could be disbursed immediately, possibly within the same year, aid inflow required to attain the target GNP growth rate of 6.5 percent would be forthcoming with or without PAP.

Based on recent experience, however there is usually a lag of a year or two (see section on recent aid absorption performance) in translating pledges into commitment depending on the source of aid and the form in which it is made available. Assuming that pledges not committed immediately during the same year can all be carried forward to the second or even third year, these pledges would eventually be committed beyond the plan period unless the recipient finally refuses the aid offer altogether.

Even assuming that projected annual commitment is realized, disbursing it entirely within the same year would not be possible as long as aid is projectized. Depending on the proportion of aid programmed for nonproject assistance, a certain degree of accumulation of aid commitment would be necessary to allow a desired level of disbursement. Based on IBRD data, the ratio between accumulated loan commitment and disbursement is 5:1 in 1987. Thus, if required disbursement is \$2.6 billion, required accumulated commitment would be \$13 billion. As of end 1987, outstanding aid commitment in loans but remaining undrawn stood at \$3.6 billion. At 85:15 loan/grant ratio, total ODA commitment but undrawn would only be around \$4.2 billion.

While no projection of cumulative aid commitment (inclusive of grants and of amount undrawn) is available, what might be considered as a likely level of disbursement, given a certain aid pattern with respect to origin and form, may be derived from past relationship between annual disbursement and annual

commitment. In 1980-85, the ratio of annual disbursement to commitment was 0.75 (see Chapter IV). For the period 1986-88, however, this declined to 0.70. In 1988, the ratio was 0.5. Thus, if annual commitment of \$2.9 billion projected by the NEDA Secretariat would, in fact, be realized, disbursement could be in the range of \$1.5 to \$2.2 billion, which is considerably lower than the amount of \$2.6 billion required in terms of inflows. Taking an optimistic assumption that the pledge of \$3.5 billion for 1989 in Tokyo will be maintained for the rest of the plan period and would be committed entirely, likely disbursement could be in the range of \$1.75 to \$2.6 billion.

Detailed projection made by the NEDA Secretariat of aid inflow from past and projected commitment before the Tokyo conference by source, showing a higher average annual inflow of \$1.5 billion (see Table VII-6) may be considered too optimistic.

Considering past disbursement performance of about \$1 billion annually, \$1.5 billion annual disbursement level for 1989-1992 would imply an improvement of 50 percent, more optimistic than the Bank's projection of improvement in disbursement performance from \$1.2 to \$1.4 billion. The rate of inflow of \$1.5 billion annually is based on projected annual commitment level of \$2.9 billion without PAP, yielding an implied disbursement/commitment ratio of around 0.5. Even assuming that with PAP annual commitment would be \$3.5 billion, the likely rate of disbursement would only be \$1.75 billion, which is still way below aid inflow requirement of \$2.6 billion.

Thus, unless there is a dramatic change in the aid delivery mechanism away from project assistance in favor of nonproject assistance, including use of aid for various types of debt relief, an amount ranging from \$1.2 billion to \$1.75 billion annually is what may be considered feasible and manageable in terms of actual aid inflow. The latter amount may also be viewed as the upper limit to the

country's aid absorptive capacity under existing composition of aid in terms of origin and form. Unfortunately, it is still lower than what is potentially available in terms of annual commitment ranging from \$2.9 billion to \$3.5 billion and what is required amounting to \$2.6 billion to sustain the growth rate of over 6 percent achieved in 1988. In a sense, therefore, there is an aid absorptive capacity gap constraining economic growth.

TABLE VII-6: Philippines: Projected* Inflow (Disbursement) from Aid, 1989-1992 (In millions of U.S. dollars)					
	1989	1990	1991	1992	1989-1992
Multilaterals					
ADB	215.6	326.7	313.9	355.3	1211.4
IBRD	320.2	296.4	305.7	337.8	1260.1
UN System	13.8	8.0	3.5	2.0	27.3
Others	30.8	34.0	13.9	3.8	82.6
Bilaterals					
Japan	370.6	370.8	397.1	386.9	1525.4
U.S.	307.3	294.0	247.0	180.4	1028.7
Canada	23.2	21.4	18.5	18.6	81.7
FRG	28.8	31.8	29.7	11.8	102.1
Italy	112.3	92.9	90.4	16.5	312.1
France	27.3	15.4	5.9	14.7	63.3
Spain	8.0	5.6	15.0	15.0	43.6
Belgium	5.4	2.7	-	-	8.1
Denmark	8.4	3.4	4.8	2.0	18.5
U.K.	28.4	15.4	-	-	43.8
Australia	29.5	20.1	4.4	4.9	58.9
New Zealand	0.7	-	-	-	0.7
Singapore	0.4	2.0	1.6	-	3.9
Hong Kong	7.5	7.4	-	-	14.9
Switzerland	-	-	-	-	-
TOTAL	1532.5	1540.7	1451.2	1349.8	5874.2
*Based on data available as of March 1989					
Source: NEDA, Public Investment Staff					

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