

Policy Priorities for Foreign Aid Reform: a case for Nepal

Background

- The developed economies are still debt-driven & face challenges to revive to the pre-crisis export-led growth sooner.
- Need is developing a more consumer-centric economy in the region – one in which rising consumption is increasingly fed by production from within the region.

Background.....Contd.

- **The policy for standard reform programs includes:**
 - **Improving performance of public sector economic institutions** (strengthening public expenditure), and
 - **Designing macroeconomic and sectoral economic policy measures** (reducing fiscal and BOP deficits by restraining public expenditure growth, tightening monetary policy, and adjusting the exchange rates)

Foreign Aid in Nepal

- As foreign aid is function of both demand and supply factors, the flow can be attributed to both increase in developmental activities and number of donors – instability & reduced investments
- After the peace accord of **2006** with Maoists, the increased ODA of \$514 million financed 81% of **2007/08** capital expenditure and 26.5% of all government expenditure.
- Inter-party & intra-party conflict, mushroom growth of insurgence groups in country's diversified regions, Nepal's peace process is in dilemma impacting on disbursement.

Significance of Foreign Aid in Budgets and Fiscal Policy

- Historically, Nepal as a part of fiscal policy has practiced deficit budgets.
- Early **1990s** - fiscal deficit (expenditure-revenue gap) of total expenditure was 50% but after **90s** Policy reform, deficit declined to 33% by **2007/08**.
- The added uncertainty on finalizing new constitution and holding general election has delayed state restructuring, as a result, disbursement is far behind commitments.

Significance of Foreign Aid in Budgets and Fiscal Policy.....Contd.

- As the S-I gap is difficult to meet through domestic sources of financing, and total consumption accounts almost 88 percent of total GDP, aid becomes indispensable.

Foreign Assistance and Development

- Study in Nepal shows, in the long run aid is positively related to **per capital real GDP**. The issue therefore, is not to find out it's contribution to GDP & development. The question is:
 - a) **Whether foreign aid has been used effectively?**
 - b) **Has it been able to channelize most productive sectors so that development activities have been accelerated & sustained?**
 - c) **Is there any scope for improving allocative efficiency of the foreign aid?**

Foreign Assistance and Development.....Contd.

- External assistance is **not value free**. The aid targeted for developmental projects is often times alleged to have directed towards the **political and strategic** interests.
- If the key objective of ODA is to promote development, it should be linked to the priorities.

Sectoral Allocation of Foreign Aid and Policy Priorities in Nepal

- **While Nepal shifted development priorities over the years, foreign financing followed the suit.**
- The total resource flow during the period of **1990 to 1998** in the basic social services sectors (primary schooling, drinking water and sanitation, health, and family planning), increased on an **average annual rate of 11.4%**.
- **Insurgency deteriorated after 2000 and priority sector funding lost the track.**

Contribution of Foreign Assistance to Development Goals

- Literatures show, foreign aid not achieving much in development goals.
- Prof. Easterly: **West spent \$2.3 trillion** on foreign aid over the last five decades and still had not managed to get:
 - * **twelve-cent medicines to children to prevent half of malaria deaths;**
 - * **four-dollar bed nets to poor families;**
 - * **three dollars to each new mother to prevent five million deaths.**

Contribution of Foreign Assistance to Development Goals....Contd.

- The **policy reform-based conditional loans** to Africa and many other countries including Latin America, remained **discouraging**.
- **It is alleged that \$568 billion were spent on aid to Africa, and yet the typical African country is no richer today than 40 years ago.**

Contribution of Foreign Assistance to Development Goals....Contd.

- Donors are always behind their commitment to offer 0.7% of their gross national income as ODA. If **broken down by regions over time, the poorest countries get less.**
- Net ODA in \$ term is not discouraging but as % of GNI it is still below commitments.
- **The level of aid did not increase when GNI of rich countries increased. It was some \$100 billion short during 1990-2009.**

Contribution of Foreign Assistance to Development Goals....Contd.

- Studies reveal developmental aid is satisfactory but not enough.
- Since flow of foreign aid is also the function of governance, such high discrepancy between commitment & disbursement is attributed to political instability.

7. Key Issues

Opportunity Costs contd.

Complimentarity

- There are two schools of thought on aid –
 - (a) it sustains corrupt government and works as a disincentive for domestic resource mobilization;
 - (b) complements domestic savings and supports growth and poverty reduction.

7. Key Issues.....cont

Opportunity Costs....complimentarity

- Most aid does not actually go to the poorest who would need it the most.
- Large projects or massive grand strategies often fail to help the vulnerable; money is often embezzled away.

7. Key Issues.....cont

- Opportunity Costs.....cont. conditionality
 - Because of inexperience, Nepal is seen endorsing disparate conditionality.
 - Fails to involve project-specific qualified local consultants in the agreement.
 - Procuring construction materials, equipments, & vehicles from donor is common conditions linked to aid.

7. Key Issues.....cont

Opportunity Cost...Conditionality

- (b) All consultants and technicians from donors.
- (c) Often times, contract needs to be provided to them as recommended by donors.
- The practice of enforcing conditionality tied to aid has constrained the use of appropriate and less costly technology, materials and services.

7. Key Issues.....cont

Debt Burden

- Nepal received more than 450% loan after restoration of democracy than during the Panchayat regime. However, country suffered huge loss from currency depreciation.
- The stock of net outstanding external debt in 1996/97 was Rs. 132086.8 m, which reached to Rs. 249965.4 m in the year 2004/05.
- Debt service ratio remains around **one third to one fourth of the annual regular expenditure.**

7. Key Issues.....cont

Effectiveness

- Experience is poor in contributing to economic growth and poverty reduction.
- It is argued foreign aid being supply side driven attributes solely to **motives and objectives of donors.**
- Literatures show varying impact under various policy environments with differing quality of governance.

7. Key Issues.....cont

Effectiveness....contd.

- In Nepal relationship between aid and per capita real GDP is found to be negative in both aggregate and disaggregated forms in the short-run (absorptive capacity and high aid volatility)
- It was **effective when moderate in volume**, if not, counterproductive, which erodes institutional quality, & increased corruption.

7. Key Issues.....cont

Future Policy Priorities

- ** Although global crisis is not over, donors can be expected to continuing external assistance largely for humanitarian and political motives, security consideration, & global health.
- ** Donors involvement in multiplicity of projects lacks coherence and strategy necessitating policy reforms for greater efficiency and credibility.

7. Key Issues.....cont

Future Policy Priorities.....contd.

- Based on Paris Principles on Aid Effectiveness and Accra Agenda for Action, a draft Foreign Aid Policy, 2009 aims at developing and adopting a roadmap through a National Action Plan (NAP) on Aid Effectiveness.
- Draft aid policies propose enhancing domestic resource mobilization capacity for financing long-term sustained growth.

7. Key Issues.....cont

Future Policy Priorities.....contd.

- Diversion of huge resources for meeting MDGs goal may at times backfire productive capacity. Some emphasize on **financing economic structure** to generate revenue to complement to social sector development.
- The need for aid utilization can be reiterated from U.S. President Obama's statement on need for reforming U.S. foreign-aid policies – **“Western consultants and administrative costs ended up gobbling huge percentages of their aid overall”**.

7. Key Issues.....cont

Approaching “new donors” like China and Middle Eastern Countries

- Literature shows China wants to test itself how it can be a new international power center by extending development assistance to Asia and Africa.
- It is possible that as both China and United States are oil consumers, there is potential for US-China cooperation in the region.
- The communists combined together are larger than democrats. China could neutralize political risks in development projects.

7. Key Issues.....cont

- Approaching “new donors” like China and Middle Eastern Countries....contd.

- It may be worthwhile to discuss if China's **state-driven development model without conventional political reform** can be replicated?
- Since China is positive, it should be Nepal's priority to expedite the planned highway to connect Nepal to Tibet.
- China's capital and technology with Nepal's untapped resources can benefit both countries enormously.

7. Key Issues.....cont

Approaching “new donors” like China and Middle Eastern Countries....contd.

- With regards to Arabian sources of grants, it still is very modest, which is less than that of Sweden alone.
- In the Middle East, Saudi is by far the biggest donor to WFP's global activities and the 16th largest donor overall to the UN food aid indicating future potential.

7. Key Issues.....cont

Exit Policy for Aid

- Draft FAP, 2009 realizes that to bail the country out of its low-income status, ODA is needed until the country reaches the middle-income status in the next 10 to 15 years' time.
- Despite increasing aid, Nepal lacks optimizing the gain from aid (lack of ownership, lack of leadership and direction in designing, preparing, and implementing projects etc.)

7. Key Issues.....cont

Exit Policy for Aid....contd.

- Priority-based aid has raises the question ***whether these priorities are set independently by the government or not?***
- enhance the nation's capability to envision, implement and sustain
- Before thinking to take exit, FAP needs to be made compatible w/proposed state restructuring.

8. Conclusions

- Nepal's FAP is undergoing a major overhaul (2002, 2008 and 2009).
- Comprehensive reform programs should address changed global environment for accessing economical & competitive lending.
- Nepal's post-conflict regime necessitates especial policies on the security management, peace building and economic revitalization. It is difficult but possible, which prepares country for taking exit.