How Aid Can Promote Exports 3

Aid programs normally promote national exports to some extent. One way is by "reflow," the spending of aid money on goods and services from the donor country. A second way is that a country's own aid programs can help national firms to tap into aid finding from multilateral organizations. A third way is that the recipient country's use of goods and services from the donor country can open the door to long-term commercial relationships. Certain practices tend to increase aid's export promotion effect, whether or not they are adopted for that purpose. This chapter describes such practices in the abstract; their actual use is discussed in chapter 4 (for practices increasing reflow), box 2-C (for practices that help firms tap into multilateral funding), and box 2-B (for practices increasing the chance that aid will lead to long-term commercial relationships).

PRACTICES THAT INCREASE REFLOW

Some reflow occurs naturally. The donor country may offer the best bargains in goods and services. Also, the recipient country might prefer to buy from donor country firms because of a common language, similar culture, or previous commercial relationships.[1] The recipient country might also buy from the donor out of gratitude, or out of a spontaneous belief (not encouraged by the donor) that to do so will increase the prospects for future aid from that donor.

Some donor practices can increase reflow, whether or not that is why the donor adopts the practice. Some of these practices are at times criticized on the ground that they inappropriately

[1] Catrinus J. Jepma, *The Tying of Aid* (Paris: OECD Development Centre, 1991), p. 25.

subordinate development goals to the donor's own commercial goals. One practice, which is not normally subject to such criticism, is to focus aid on projects requiring goods and services that donor country firms can supply competitively. This practice can substantially boost reflows.

Another practice, which is subject to the criticism just described, is the 'tying' of aid, i.e., restricting where the aid can be spent. In collecting statistics, the DAC distinguishes three categories of aid. First, aid that may freely be spent in all OECD countries and in substantially all developing countries is called "untied." (Aid earmarked to finance the recipient's local costs is also counted as "untied.") Aid that is not "untied" but nevertheless may be spent to procure goods and services from at least the donor country and substantially all developing countries is called "partially untied." All other aid is called "tied." Often "tied" aid is restricted so that it can only be spent in the donor country; and by "tied aid" people often mean aid so restricted, even though the DAC definition is broader, encompassing any set of conditions not meeting the definitions of untied or partially untied aid.

Tying generally increases reflow, though it is usually hard to tell by how much. In some cases, the recipient country would have spent money in the donor country even if the aid were untied.

In principle, the tying status of particular aid funds depends on the actual, practical restrictions on spending rather than on the formally declared restrictions. Thus, aid is defined to be tied when it is "*in effect* tied to procurement of goods and services from the donor country.' This situation is sometimes called "informal' tying, as opposed to the "formal" or openly announced tying. In practice, however, member countries can report figures as they wish, and the DAC does not often revise them; so informal tying might go unreported. Informal tying would occur, for example, if a donor invited bids in advance of finally deciding to fund projects, and consistently decided to fund only those projects for which its national firms would win the contract.

Sometimes donors act in ways that do not guarantee that aid will be spent in the donor country, but make that outcome more likely. This too is often referred to as "informal tying." For example, a donor might let it be known that if aid funds are not spent substantially on donor country goods and services, future aid will be diminished. Another example is an administrative system that helps national firms to influence project selection (see ch. 4).

Sometimes formally tying only a small amount of aid can informally tie a much larger amount. One example is tied grants for consultation services in the pre-project phase. Large social or capital projects are not normally undertaken without some preliminary examination of the project's context, scope, planned methods of implementation, and likelihood of success. This preliminary phase can go by the name of pre-project studies, scoping studies, pre-feasibility and feasibility studies, and (for capital projects) engineering studies.

The results of these early studies can have a ripple effect on the entire project. The firm performing the study might itself be capable of doing or at least managing the construction; its work in the pre-project stage would often give it a substantial advantage in bidding on the project.[3] Even if the firm performing the pre-project study cannot bid on the project, if the project requires technology (such as for air pollution control equipment), that firm is likely to be more familiar with donor country technologies than with for-

2 OECD, "DAC Adopts Revised Guiding Principles For Associated Financing and Tied, Partially Tied, and Untied ODA,'' Press Release A(87)23, Paris, 1987 (emphasis added).

3 The Japanese International Cooperation Agency (JICA), for example, "recommends that the recipient country employ the same consulting firm [to manage a JICA project] that took charge of the Basic Design work [a preliminary study], " in order "to secure technical consistency of the project design, etc." JICA, "Grant Aid and JICA,'' undated, p. 12.

eign ones and to recommend technical specifications that can be met by donor country vendors. This could steer the main project to national firms even if the main project is not formally tied.

Similarly, once a construction project goes ahead, a donor could tie just the aid for hiring an engineering consulting firm to manage the project. A national firm in charge of setting specifications, and in a position to advise the recipient government on procurement, would tend to steer business toward other national firms.

Another practice that can increase reflow is to give aid not as a pure grant, but with some loan component. Assuming the loan is paid back, if the aid is spent in the donor country, then the amount of reflow will actually exceed the net cost of the aid to the donor. The aid can be given in various forms. For example, the donor might give the developing country a grant, plus a loan on terms similar to those for commercial loans.[4] Or the donor might give a "concessiona1 loan," that is, a loan at terms better than those available in the markets Other possible forms include giving both a grant and a concession loan, o, both a confessional loan and a loan on close to commercial terms. Aid with a loan component is often used for major projects (such as wastewater treatment plants), which are normally too expensive to fired by grants alone.

When aid with a loan component is tied it is called a "tied aid credit. "[6] (The term "tied aid credit" is commonly used to include both tied and partially untied aid; it is so used in this background paper.) Assuming the loan is repaid, tied aid credits can leverage a given net cost to the national treasury to yield substantially larger amounts of exports. Tied aid credits also have the potential to skew aid in directions that serve donor country commercial interests over recipient country development and environmental interests, and their use is limited by international rules (see ch. 4).

PRACTICES THAT HELP FIRMS TAP MULTILATERAL FUNDING

A nation's own aid programs can help its firms in two ways to win contracts from multilateral aid sources. First, a nation can provide tied or untied grants to perform preliminary studies for projects being considered by a multilateral aid source. If a national firm does the preliminary study (which is assured if the grant for it is tied), it may steer the main project to a national source, as discussed above in the context of bilateral aid. (However, multilateral sources normally have strict and effective competitive bidding rules that could limit the influence of the firm doing the preliminary study.)

Second, a nation can provide cofinancing or parallel financing for multilateral projects. Cofinancing is money contributed directly to the multilateral project. Competitive bidding is run under the normal rules of the multilateral organization, so in principle the cofinancing gives donor country firms no advantage. However, especially if the cofinancing represents a large part of the total project cost, the recipient country will likely be especially receptive to bids by firms from the country giving the cofinancing. Parallel financing is tied or untied financing for a project separate from but closely related to the multilaterally funded project; for example, parallel financing could be for a training program on how to operate a facility whose construction is financed multilaterally. Parallel financing cannot directly influence the procurement for the multilateral project; however, national firms that bid on the parallel

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4 Government guarantees of commercial loam are also sometimes used.

5 Such a loan can be thought of conceptually as equivalent to a commercial loan (with a face value equal to the present value of the required repayment stream) combined with a grant, and might in fact be built out of those two components by the donor government.

6 The term "aid" signifies there is a grant component, while the term "credit" signifies there is a loan component (some amount must be repaid).

financing can thereby learn about the multilateral project, for which they might then bid as well.

PRACTICES THAT ENCOURAGE LONG-TERM COMMERCIAL RELATIONSHIPS

In the long run, continually giving out aid is an expensive way to promote exports. A more profitable way is to let particular aid efforts mature into long-term, self-sustaining commercial relationships. One practice that can encourage such relationships is to focus aid on countries with promising markets.

Another practice that can encourage long-term commercial relationships is "technology cooperation. This includes technology demonstrations, research and development centers, training programs, and technical assistance to nascent institutions, such as a government environment agency. Aid for these activities is often tied or partially untied.[8] Technology cooperation may over time both increase a developing country's desire and ability to protect the environment, and increase its awareness of how the donor country's technology can help with that task. Technology cooperation can reach different groups within the recipient country, including government policymakers, universities, industry, and nongovernmental organizations. While technology cooperation can have significant commercial benefits for donors, it can also be essential to achieving broader environmental and development goals.

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7 The term "technology cooperation" as used here is broader than the term "technical cooperation" used by DAC.

8 To the extent that aid is offered in goods and services (e.g., training, equipment) rather than in cash, it is by definition tied if the goods and services are produced in the donor country.