Prioritizing ODA and other Public Investment Sources as Part of a Prudent Public Debt Management Strategy

Jonathan Pincus

November 2017

After decades of a relatively high level of public investment including from ODA concessional loans, low middle income Viet Nam, in its transition towards ODA graduation, is facing a changing development finance landscape. The public debt is approaching the public debt ceiling set by the National Assembly, while its need for development finance remains very high.

Embarking on a more inclusive and sustainable development pathway to achieve Viet Nam's Sustainable Development Goals requires Government of Viet Nam to develop and apply new strategy and approaches in financing its development in general and in mobilizing and utilizing ODA loans in particular. Following the National Assembly's approval of the Law on Public Debt management, Ministry of Planning and Investment (MPI) was assigned by the Government of Viet Nam to update the directions of attracting, managing and utilizing ODA concessional loans. The overall aim of the task is to enhance effectiveness of mobilization and utilization of *ODA concessional loan* projects while maintaining the prudential public debt management.

Responding to the MPI's request for support, UNDP has commissioned an international consultant's paper as inputs to drafting the MPI-led Report "*Updated orientation for mobilization and utilization of ODA and concessional credit in the period 2018-2020, with a vision to 2021-2025*". The paper, drawing from international experience and economic theory, presents a framework for prioritizing public investment projects, including ODA loans, bearing in mind the public debt ceiling approved by the National Assembly, and provides a set of selection criteria as well as an institutional framework for the allocation of public investment funds.

The United Nations Development Programme

304 Kim Ma Street, Ba Dinh District, Ha Noi, Viet Nam
Tel: +84 4 38500100
Fax: +84 4 37265520
http://www.vn.undp.org

Introduction

This paper presents a framework for prioritizing public investment projects, including overseas development assistance (ODA). It is intended as input into the government's New ODA Directions draft document bearing in mind the public debt ceiling approved by the National Assembly and implemented by the government. While Viet Nam is not a heavily indebted country, persistently high fiscal deficits in recent years have heightened concerns about the economic risks associated with a rise in debt service obligations. The debt ceiling will motivate the government to achieve a more sustainable fiscal balance through a combination of widening the tax base and reducing spending, including more careful use of public investment resources, including ODA.

What follows is an attempt to provide a set of selection criteria and an institutional framework for the allocation of public investment funds based on international experience and economic theory.

The paper makes three main arguments.

1. Macroeconomic theory and evidence from the region suggestion that *the main use of overseas aid is providing access the financing of foreign exchange requirements* that arise in the implementation of the public sector capital investment program. The balance of payments constraint is the key bottleneck faced by developing countries during the industrialization process, and one that surfaces with particular urgency during cyclical downturns. ODA can provide long-term loans to finance necessary imports of capital goods and technology. While recognizing that external borrowing is not a substitute for exports, the judicious use of ODA can help reduce pressure on the balance of payments over the short to medium term as domestic productive capacity develops. The stability of aid flows is an important determinant of their utility in helping developing countries to relax the balance of payments constraint during the early phases of industrialization.
2. As a corollary to the point made above, *middle income countries should refrain from using ODA to finance projects that do not require foreign exchange to acquire capital goods or technology*. The practice of acquiring obligations in foreign currencies to finance local expenditures should be avoided, as it adds to the stock of external debt without, in most cases, increasing the country's ability to service these debts.
3. Developing countries should instead focus aid on *growth-enhancing* capital projects—preferably investments that contribute to the country's capacity to earn foreign exchange over the medium to long term. The use of ODA should always bear in mind the need to acquire revenue and foreign exchange in the future to service public debt and to finance imports of essential capital and intermediate goods, demand for which will rise during the process of industrialization. Infrastructure (roads, rail, ports, power supply) provide essentially inputs into the growth process, as do investment in the agricultural sector (irrigation and drainage, agricultural research, rural electrification).
4. The impact of ODA is reduced by fragmentation and politicization of aid allocation. ODA can make a significant contribution to national productive capacity if it is

concentrated on viable projects that transform the country's productive capacity. Using aid budgets to pursue multiple objectives across a range of sectors and regions increases the administrative burden on government and generates diseconomies of scale and scope. Careful coordination of development planning, fiscal policy and project selection are needed to reduce fragmentation and focus resources on investments that generate the highest economic returns. The systematic use of objective indicators and independent assessment are essential to avoid the politicization of the aid allocation process. More transparency in project selection, including oversight by the National Assembly, can play a useful role.

The contention of this paper is that the draft New ODA Directions document should keep these three points in mind in planning the government's ODA policy. After a brief discussion of the context, the paper reviews international experience, focusing on the relevant aspects of aid programs in the largest ODA recipient countries in Asia. It then set out the rationale for concentrating on growth-enhancing public investments and discusses the allocation process required to rationalize investment choices. It then considers the idea of the "savings gap" before summarizing the appropriate criteria for ODA project selection.

Background

Since the 2008-2009 global financial crisis, Viet Nam has recorded larger than normal fiscal deficits and a rapid accumulation of public debt (see Figure 1). Several factors have combined to drive up Viet Nam's fiscal deficits over the past decade. As in most countries in the region, the government increased spending as the global crisis unfolded to substitute for export demand and prevent a sharp downturn in economic activity. After a brief period of consolidation, deficits resumed their upward trajectory in 2012, driven the combined effects of revenue shortfalls and a rise in routine expenditures. Tariff reductions, lower corporate tax rates, VAT exemptions and a fall in global oil prices suppressed revenue growth, while on the expenditure side government salaries, social security obligations and interest payments on government debt more than offset a slowdown in public investment.

Viet Nam is not a highly indebted country, and although the level of interest payments on public debt have risen in recent years they are not out of line with other countries in the region (Figure 2). Interest payments on public and publicly guaranteed external debt were equal to just 0.5% of exports in 2016. As a country that has only recently acquired middle-income (MIC) status, much of Viet Nam's external debt (40%) was acquired at concessional rates. In standard debt sustainability analysis, the stock of debt is self-stabilizing if the real interest rate-growth rate differential is negative (in other words the average real interest rate on all forms of debt is less than real GDP growth). Given Viet Nam's growth record and low average real interest rates on foreign and domestic debt, the government will have the capacity to service the existing stock of debt out of government revenue barring a major economic shock. The main challenges at present are containing future deficits and managing the government's debt portfolio to reduce financing costs at acceptable risk levels.

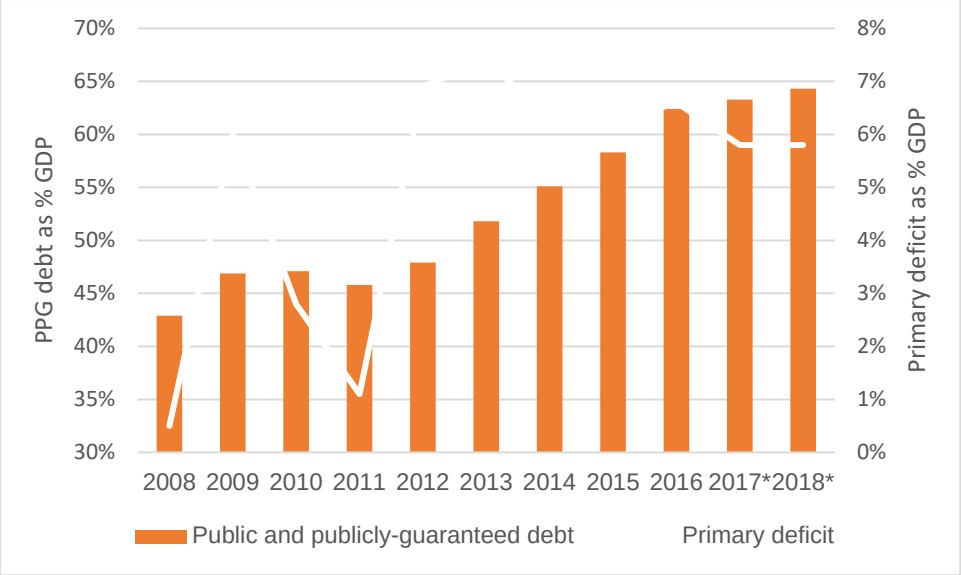

FIGURE 1. PUBLIC AND PUBLICLY GUARANTEED DEBT AND PRIMARY DEFICIT, 2008 TO 2018 (SOURCE: IMF)

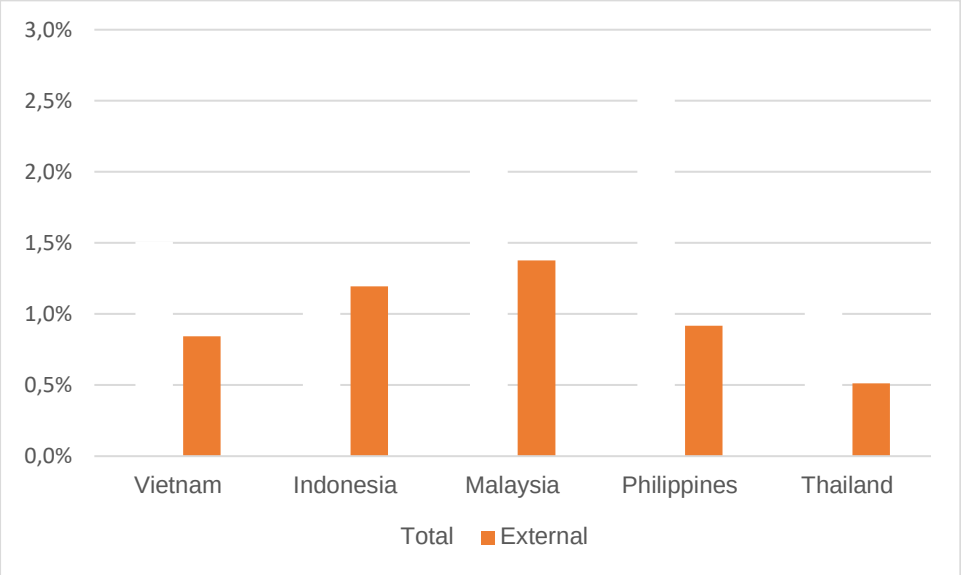

FIGURE 2. INTEREST PAYMENTS ON TOTAL AND EXTERNAL PUBLIC DEBT AS % GNI, 2015 (SOURCE: WORLD BANK)

Nevertheless, the sudden rise in the government's stock of debt has heightened concerns about the economic risks associated with excessive borrowing. Viet Nam's graduation to middle income status means that access to concessional ODA loans is now limited, which will raise average interest rates on public debt over the medium term. The large stock of external debt leaves the government vulnerable to exchange rate risk in the event of a sharp downturn in international trade or freezing of credit markets such as that experienced in 2008-2009. The government's increasing reliance on the domestic bond market exposes the government to increased interest rate risk, and the shorter maturities of these instruments results in higher financing costs. The fact that 70% of domestic bonds are acquired by local banks

imposes some additional risks on the financial system, as any sudden fall in the value of government bonds would have immediate, negative consequences for the banks' balance sheets. Implicit guarantees on debt acquired by state-owned enterprises and local authorities are another important source of risk to debt sustainability.

In response to these concerns, the National Assembly approved a resolution on the country's five-year financial plan in November 2016 that imposed ceilings of 65% and 54% of GDP on total and central government debt, respectively. The foreign debt ceiling was set at 50% of GDP. The targets were confirmed in the medium-term debt management strategy signed by the Prime Minister in April 2017. By the end of 2016 total public debt and central government debt stood at 63.7% and 52.7% of GDP, respectively, and according to Ministry of Finance estimates the 65% limit will be reached by the end of 2017.

In a related development, the National Assembly recently approved a revised Law on Public Debt Management that assigns this task to the Ministry of Finance, replacing the previous system in which responsibility was share with the Ministry of Planning and Investment and the State Bank of Viet Nam (SBV).

The introduction of a debt ceiling, if credible, will have the effect of creating a hard budget constraint, motivating the government to intensify efforts to broaden the tax base and to make difficult choices with regards to public investment and current spending. The harder the budget constraint, the more urgent will be the need to reduce the primary deficit through some combination revenue enhancement and spending cuts. Centralizing the technical aspects of debt management within a single agency will help the government achieve an appropriate cost-risk balance in the administration of the national debt.

However important, these steps do not directly address the central issue of maximizing returns to public investment, including overseas development assistance (ODA). Spending and debt limits are blunt instruments of fiscal policy: they can force hard choices, but they do not provide criteria on which these choices should be made. In the remaining sections of this paper we will offer several core principles of aid allocation, based on international experience and economic theory. Our main conclusions are that:

- The main benefit of ODA is to contribute to the balance of payments, which is the binding constraint facing middle-income, industrializing countries;
- With this principle in mind, ODA choices should focus on *growth-enhancing* projects that require foreign exchange for the import of capital goods and technology, and to the extent possible selected ODA projects should strengthen the country's ability to earn foreign exchange;
- Fragmentation and politicization of aid allocation reduces effectiveness and impact; ODA should be concentrated on a limited range of transformative projects;
- To achieve these objectives the allocation process should be based on objective criteria and make use of independent assessment to the greatest extent possible.

We are confident that these principles, if incorporated into the new draft ODA diretions, would reduce the negative effects of overborrowing and would maximize the impact of ODA in the future.

International Experience

A fundamental misconception lies behind most public debate about overseas development assistance. The general public, and even many aid practitioners, assume that developing countries do not have sufficient domestic savings to finance public investment, and that the main function of ODA is to fill this "savings gap." In part, this belief stems from a tendency to confuse "above the line" transactions in public finance (government revenue and expenditures) and "below the line" transactions (financial flows required to finance deficits and invest surpluses). Public investment projects that meet the government's established criteria (economic rate of return, or similar indicator or set of indicators) are deemed worthwhile investments and are included in annual accounts above the line. The project's financial structure, to the extent that it includes external and/or domestic borrowing, will be aggregated within the government's financing plan below the line. While the availability of ODA at preferential rates may marginally affect the financial and economic rate of return and hence the project's viability, there usually exist alternative sources of finance (bonds, commercial loans, and equity participation) to finance good projects. Capital is not the binding constraint in most middle-income countries.[1]

The main bottleneck faced by developing countries is not access to savings, but access to timely and sufficient supplies of foreign exchange needed to acquire essential imports of capital goods and technology during the industrialization process. Viet Nam's recent experience has demonstrated that the balance of payments is the key driver of economic policy choices during periods of economic turbulence.

The balance of payments consists of the current and financial accounts, which by definition must sum to zero less errors and omissions. In Viet Nam, the size of errors and omissions are in some years a significant component of the balance of payments because of large-scale capital flight (unrecorded transfers of funds overseas by residents).

- The current account consists of the trade balance (exports less imports of goods and services), net primary income (mostly interest payments and profit remittances) and net secondary income (remittances from abroad and grant aid), as follows:

Current account balance = (exports-imports) + net primary income + net secondary income.

- If the current account is in deficit, it is financed by a surplus on the financial account, which is defined as the sum net changes in debt, net inflows of foreign direct investment, net inflows of portfolio investment (net purchases of shares and bonds from abroad) and changes in the level of the central bank's reserves, or:

Financial account balance = net change debt + net FDI + net portfolio investment + change in reserves.

- Rearranging we get:

(exports-imports) = net change debt + net FDI + net portfolio investment + change in reserves - net primary income - net secondary income.

[1] This is not the case in least developed and conflict-affected countries, which generally lack access to international capital markets and where domestic financial markets are not well-developed.

- That is, when imports are greater than exports, the difference is financed by some combination of new debt, foreign direct investment, other investment and income flows. The direction of causality can also work the other way: large investment inflows result in imports or capital and intermediate goods, widening the trade deficit. This was the case in Viet Nam in 2007-2008, when large inflows of FDI and portfolio capital drove widening trade and current account deficits (Figure 3).

Outward flows of primary income increase with the stock of external debt, as the government and private businesses repay principal and pay interest on their loans. In Viet Nam, debt service payments have increased rapidly since 2012. These payments have been financed by trade surpluses and inflows of remittances. If the trade balance were to turn negative, debt service payments would have to be financed by new borrowing. The practice of financing payments on the existing stock of debt with new loans is known as "Ponzi finance," which is unsustainable because eventually lenders will refuse new loans, forcing the country to restrict imports (through currency devaluation and demand management) to achieve large trade surpluses. Structural adjustment during the 1980s and during the East Asia Financial Crisis of 1997-1998 was an attempt to restore external balance and slow down the accumulation of debt by restricting domestic demand and hence imports.

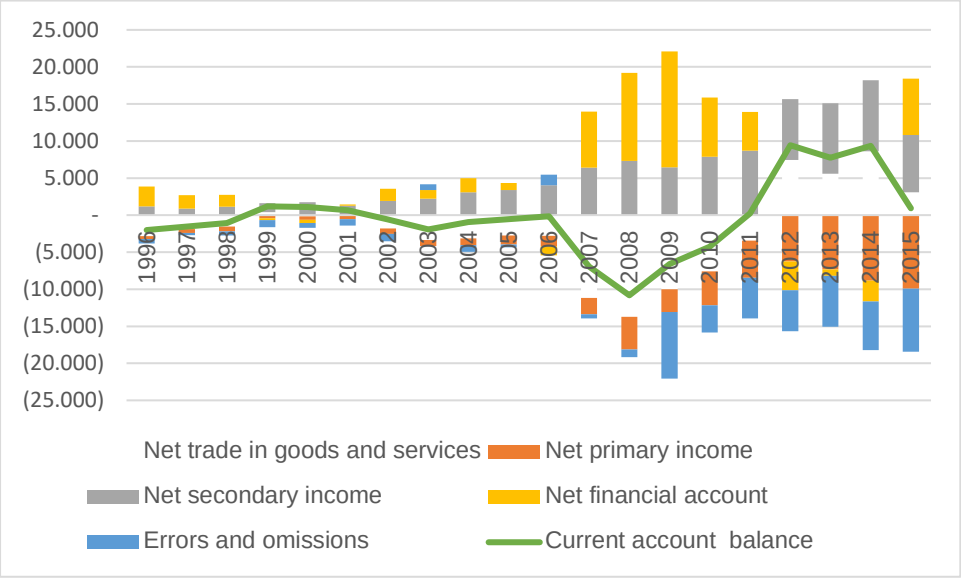

FIGURE 3. VIET NAM'S BALANCE OF PAYMENTS, 1996-2015 (MILLIONS OF CURRENT USD)

ODA is not a sustainable means of financing current account deficits over the long period. However, If it is delivered in sufficient volumes and in a timely manner, ODA can reduce the burden of importing essential capital goods and technology during the process of industrialization. Many of these goods, which are essential to developing infrastructure, industry and utilities, are not produced domestically and therefore must be imported. The advantage over other sources of capital flows is that ODA funds are typically long-term loans at below-market interest rates, which can help reduce net outflows of primary income and volatility in the volume of capital inflows. However, replacing debt with more sustainable sources of foreign exchange should be a primary objective of the aid program to reduce the risk of falling into a debt trap.

To make a difference to a country's balance of payments, ODA flows must be significant relative to the size of the economy and consistent over time. Among the large Asian countries, five have received aid in significant volumes and over an extended period of time (Figures 4-5): Korea, Pakistan, Bangladesh, Indonesia and Viet Nam. Other countries have enjoyed brief periods of significant ODA inflows, but these have not been large enough or delivered over a sufficiently long period of time to make much of a difference in terms of access to foreign exchange. For example, Thailand received significant amounts of grant aid from the United States during the 1970s (linked to the American military build-up in the region), but by the 1980s ODA was playing a very limited role in external financing.

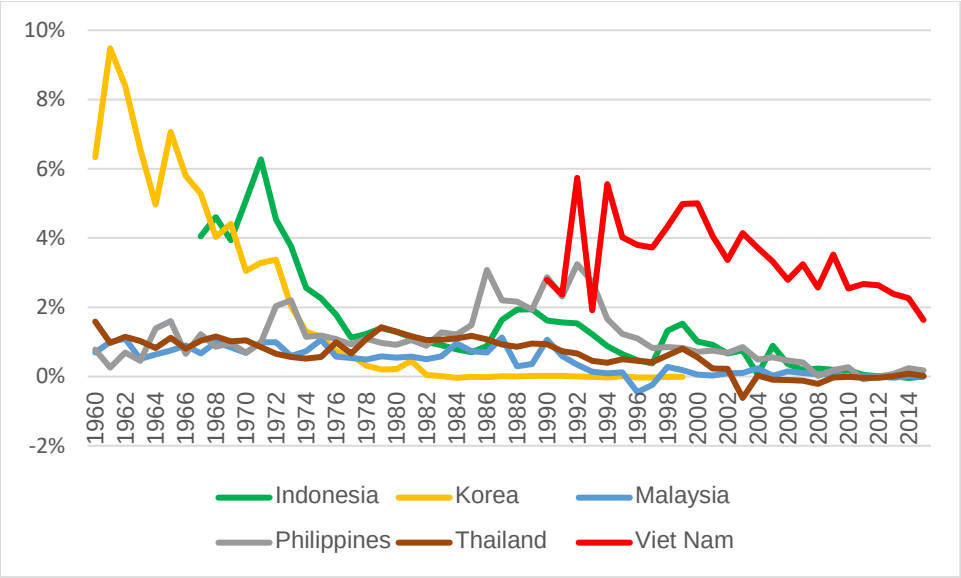

FIGURE 4. ODA FLOWS AS SHARE OF GDP, EAST AND SOUTHEAST ASIA 1960-2014

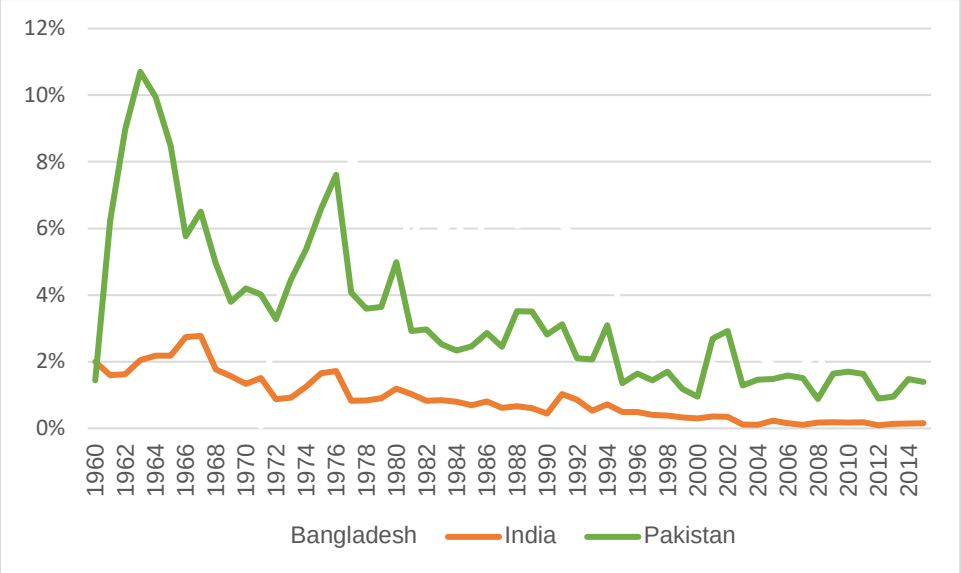

FIGURE 5. ODA FLOWS AS SHARE OF GDP, SOUTH ASIA 1960-2014

A closer look at the experience of Korea, Pakistan, Bangladesh and Indonesia helps to emphasize the following key points about the role of ODA:

- ODA is useful when flows are stable and delivered over an extended period of time;
- ODA is useful when it supports growth-enhancing public investment as part of a coherent and strategic government plan, and is linked to the country's long-term capacity to earn foreign exchange;
- Investment in agriculture was important in Korea and Indonesia, as it helped reduce food imports and conserved scarce foreign exchange, in addition to increasing earnings in the rural sector and ensuring stable food prices for the growing urban labor force;
- Once the foreign exchange constraint is relaxed through rapid growth of exports or other means, the benefits associated with foreign aid decline quickly;
- Aid is most effective when it is used for major investments that transform the nation's productive capacity, and less effective when it is fragmented and politicized.

The rest of this section briefly reviews the experience of these countries to illustrate these main points.

Republic of Korea

When the armistice was signed in July 1953, Korea was one of the poorest countries in the world. Three million Koreans had been killed in the war and millions more displaced. The country's infrastructure and industrial plant were in ruins. In the immediate postwar period, agriculture struggled in the south under the weight of input shortages, poor infrastructure, low output prices and high taxes. Corruption was rampant and firms with close connections to government made fortunes through the control of commodity aid. US General Douglas MacArthur famously predicted that it would take one hundred years for Korea to recover from the devastation of war. Most outside observers shared his pessimism.

In the thirty years from 1960 The Republic of Korea achieved the one of the most rapid and comprehensive economic transformations in world history. ODA played a positive, although minor role in the Korean miracle. From 1945 to 1999, the country received USD 44 billion in official development assistance (at current prices), consisting of seven billion in grant aid and USD 37 billion in loans. US largesse from 1964 was linked to Korea's participation in the American war effort in Viet Nam, to which Korea contributed 310,000 troops over a period of eleven years. Normalization of relations with Japan in 1965 opened another important channel of bilateral aid.

Grant aid, mostly food and humanitarian assistance, made up the bulk of transfers during the war and the first five years of reconstruction (1950-1959). Commodity aid was sold on the domestic market, financing government deficits. After 1960s, loans made up the bulk of aid receipts, and these were directed to economic infrastructure and investments in agriculture in line with successive five-year plans. South Korea also experienced two periods of structural

adjustment in the late 1970s and 1990s, which also received support from international donors. By then, however, ODA was less important to economic planning and growth.

Two facts stand out about ODA flows to Korea from the 1960s (Figure 6). First, aid flows—which largely consisted of bilateral aid from the US—were large and stable, providing a reliable source of foreign exchange during Korea's most intensive period of industrial transformation. As shown in Figure 7, South Korea was a typical foreign exchange constrained developing country, particularly in the 1960s, when the current account balance was consistently in deficit.

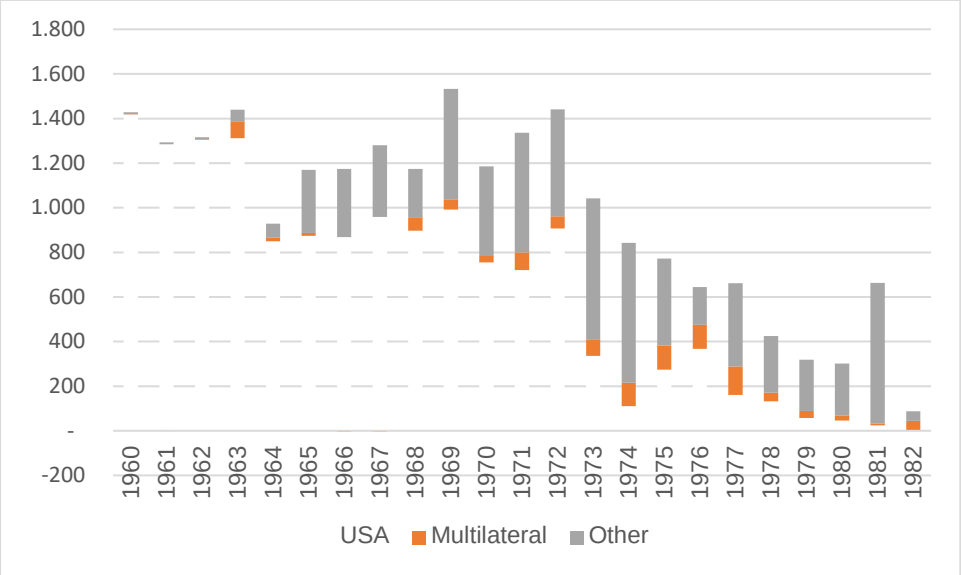

FIGURE 6: ODA FLOWS TO KOREA, CONSTANT 2009 USD

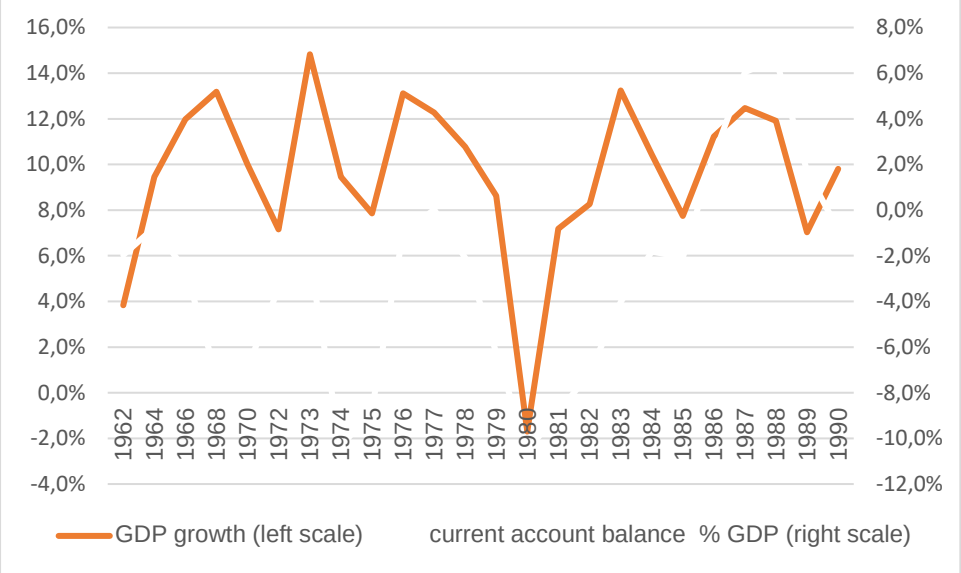

FIGURE 7. ECONOMIC GROWTH AND THE CURRENT ACCOUNT BALANCE, KOREA, 1962-1990

The second main point is that South Korea focused aid flows in two main areas: agriculture and economic infrastructure (Figure 8). Korea's emerged from war as a food-deficit country

with a traditional, low-productivity agriculture and shortages of essential inputs. Food aid solved the immediate problem of shortage but was not a viable, long-term solution. Industrialization meant moving millions of Korean workers from rural to urban areas, which could not be accomplished without substantial and sustained increased in agricultural labor productivity. The government invested heavily in infrastructure to modernize agriculture and make it more efficient, notably through the New Village Movement launched in 1970. The stock of fixed capital in farming rose by 183 percent from 1965-1975.[2]

Two-thirds of ODA loans were directed to infrastructure between 1966 and 1978, with the volume of investment increasing markedly after 1972 and the shift to a heavy industry strategy. The government took on key projects in road transport (notably the Seoul-Pusan highway), industrial estates, deep-water ports and power generation. The Seoul subway system was also developed during this period.

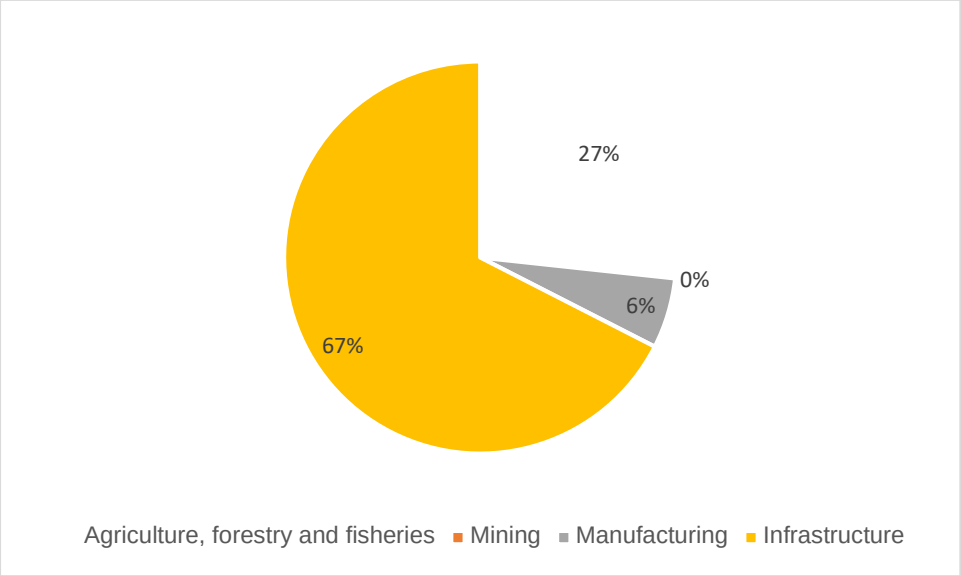

FIGURE 8. SECTORAL ALLOCATION OF PUBLIC DEVELOPMENT LOANS, KOREA 1966-1978

Crucial to the success of infrastructure development was the close articulation of five-year development plans and financing under the coordination of the Economic Planning Bureau (EPB). The EPB controlled not only planning, but also budgeting and implementation of public investment projects. The concentration of power removed obstacles to financing and implementing the plan, including decisions relating to the use of ODA funds.[3] A planning and coordination officer was installed in the prime minister's office to monitor public investment, and this post was supported by a Professors Group for Evaluation that provided independent assessment of projects.[4]

[2] Tibor Scitovsky, "Economic Development in Taiwan and South Korea," *Food Research Institute Studies*, XIX:3, 1985, p. 233.
[3] See Vivek Chibber, *Locked in Place: State Building and Late Industrialization in India*, Princeton University Press, 2006, p. 60.
[4] Lee Kye Woo, "The Role of Aid in Korea's Develoment," *Korea's Economy*, Vol. 30, p. 20.

The Korean experience illustrates that ODA can play a positive role in the process of industrialization, especially if aid flows are on a scale sufficiently large to make a difference to the balance of payments in a predicable manner. Korea used this foreign exchange to invest in the key growth-enhancing areas of economic infrastructure and agriculture. Government institutions made it possible to integrate ODA projects into economic plans, and to ensure rigorous, independent evaluation of public investment projects including ODA.

Pakistan

Pakistan ranks among the largest recipients of overseas development assistance in Asia, nearly two-thirds of which has come from bilateral sources since 1960. Like Korea, Pakistan has relied heavily on US bilateral aid since independence. However, unlike Korea, Pakistan did not benefit from consistent and significant inflows of American assistance after the early 1960s. The United States has tended to increase support during periods of military-led government, combining ODA with large flows of military aid. The lines between these categories were often blurred, as defense spending has consistently taken up a large share of government expenditures.[5] Military aid was an important factor in the 1980s, when Pakistan was viewed as a front-line state opposing Soviet influence in Afghanistan. US aid was halted following Pakistan's nuclear tests in 1998, but recommenced with the launch of military operations in Afghanistan from 2001.[6]

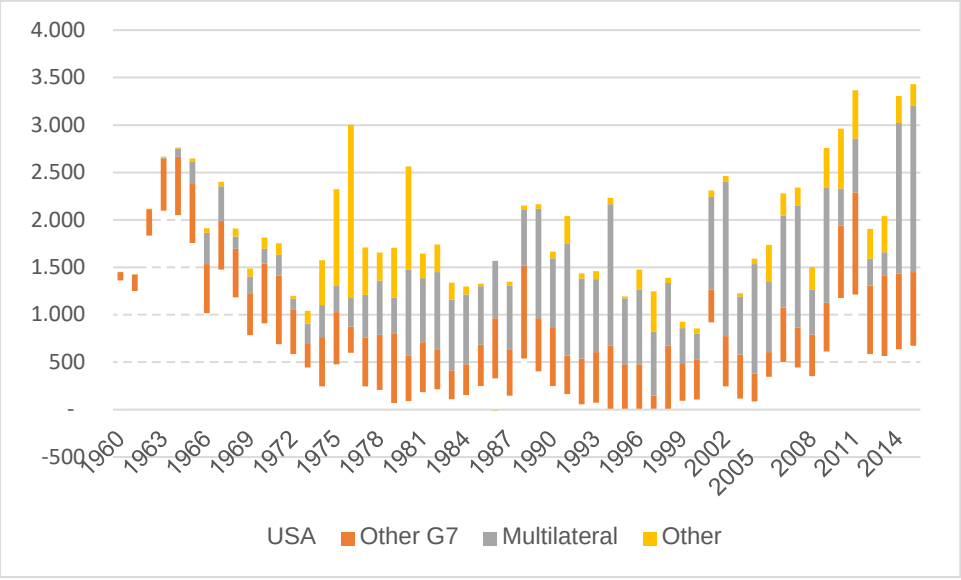

FIGURE 9. ODA FLOWS TO PAKISTAN, CONSTANT 2009 USD

Domestic factors have also contributed to boom and bust cycle of ODA flows. After partition Pakistan was a close ally of the US, which provided support for key infrastructure investments

[5] See Muhammad Arshad Khan and Ayaz Ahmed, "Foreign Aid—Blessing or Curse? Evidence from Pakistan," *Pakistan Development Review*, 46:3, 2007.
[6] Mushtaq Khan, "Aid and Governance in Vulnerable States: Bangladesh and Pakistan Since 1971," *The Annals of the American Academy of Political and Social Science*, 656:1, 2014.

including the Terbala and Mangla dams and major road projects. US support fell in the 1970s as the authoritarian-populist Bhutto government nationalized private industries and normalized relations with the Soviet Union. The military government of Zia Ul-Haq which took power in 1977, gradually reversed Bhutto's economic policy orientation, facilitating a resumption of US aid, but at lower levels. Growth accelerated but the economy performed unevenly, plagued by recurring fiscal and current account deficits. Remittances emerged as an important source of foreign exchange and even eclipsed ODA in some years. Aid declined again under the civilian governments of the 1990s as power changed hands frequently and donors concluded that politicians from all parties had lost interest in controlling corruption.

Foreign exchange constraints are still an important barrier to rapid economic growth in Pakistan. Fluctuations in the volume of aid over the years have reinforced the country's boom-bust pattern of growth, adding to the instability caused by frequent large swings in fiscal policy. Given the interactions between erratic domestic economic policy and start-stop aid flows, it is not surprising the that econometric studies of the impact of aid have failed to detect a positive relationship between aid flows and growth.[7] Although economic infrastructure accounts for the largest share of aid expenditures, unlike South Korea Pakistan has invested only a small share of ODA to the agricultural sector (Figure 11). Pakistan never succeeded in developing alternative sources of foreign exchange (other than remittances), and hence the balance of payments remains a binding constraint on growth.

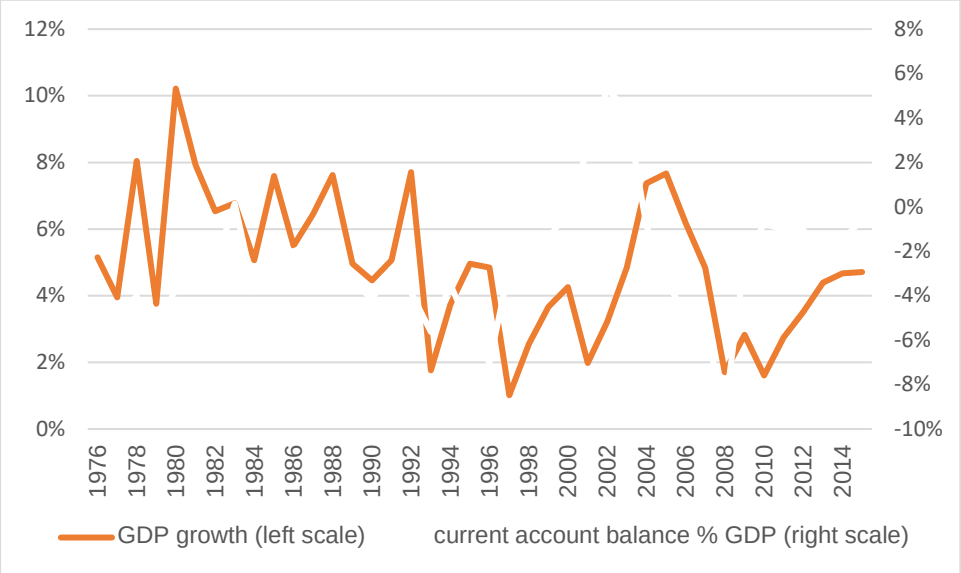

FIGURE 10. GDP GROWTH AND THE CURRENT ACCOUNT BALANCE, PAKISTAN

[7] See, for example, Azhar Mahmood, "The Role of Foreign Aid in Economic Development in Pakistan," *Pakistan Economic and Social Review*, 35:1, 1997.

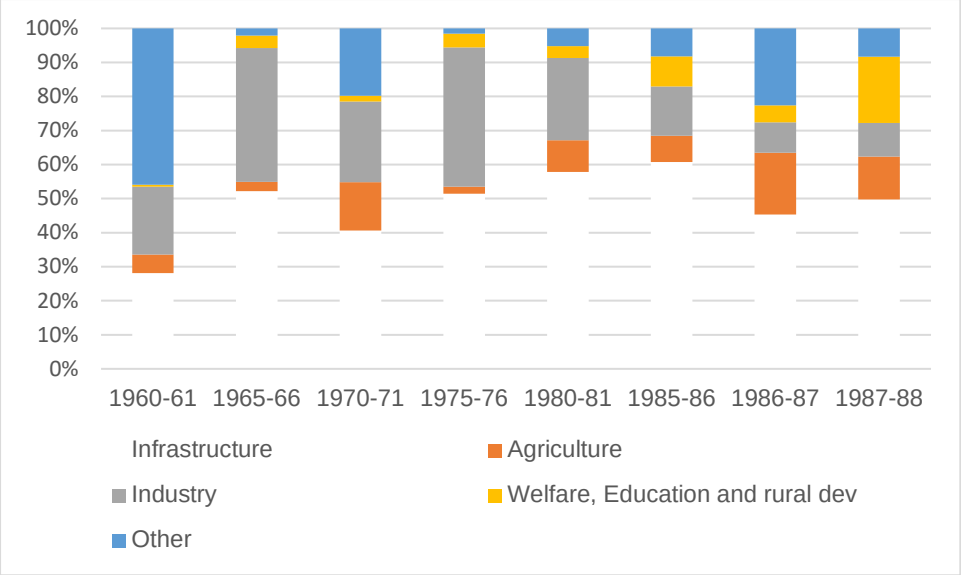

FIGURE 11. ALLOCATION OF ODA, PAKISTAN 1960-1988

Since 1960, Pakistan has received more than USD 110 billion in ODA *in real terms* (constant 2009 dollars). Yet there is little evidence that this investment has paid off in terms of economic growth. While Pakistan's relatively poor performance is due to a range of economic and political factors, the lack of consistency in the delivery of aid has contributed to its boom-bust growth pattern. Frequent changes in government and shifts in economic policy have also meant that aid has not been part of a coherent and consistently implemented growth strategy.

Bangladesh

Like Pakistan, from which it seceded in 1971, Bangladesh was one of Asia's largest beneficiaries of aid, taking in USD 90 billion in real terms since independence. Unlike Pakistan, Bangladesh has relied more heavily on multilateral agencies like the World Bank and Asian Development Bank than on bilateral donors. The volume of aid was reasonably stable in real terms during the twenty-year period after 1975 (Figure 12). However, ODA was never part of a coherent public investment strategy. Multilateral donors brought their own agenda, influenced by trends in global development thinking and the political concerns of donor governments. Lending policies at the World Bank favored integrated area development programs in the 1970s, structural adjustment in the 1980s, "good governance" in the 1990s and poverty reduction (through the planning instrument of Poverty Reduction Strategy Papers) in the 2000s. The "aid effectiveness" agenda of the early 2000s rightly emphasized the importance of government ownership and alignment with national plans, a key lesson from South Korea's success. But donors (both bilateral and multilateral) found that lacked have the political space to surrender control to recipient governments owing to the numerous and varied objectives imposed by their members and governing boards. It was never clear how these organizations could simultaneously prioritize poverty reduction, environmental

sustainability, gender equity, decentralized governance, financial liberalization and public administration reform while still "putting government in the driver's seat."

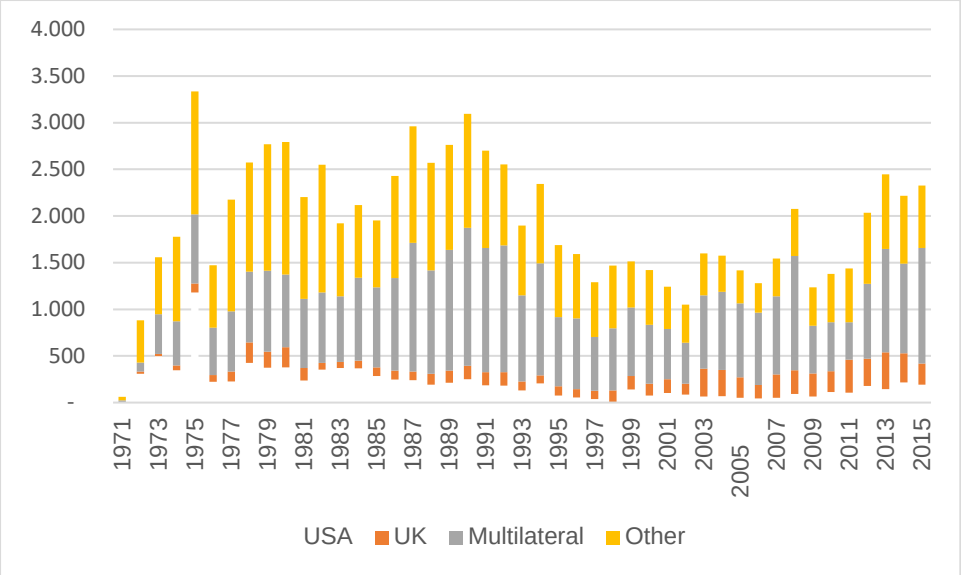

FIGURE 12. ODA FLOWS TO BANGLADESH, CONSTANT 2009 USD

Another important difference between Bangladesh and Pakistan is the central role played by non-government organizations in the delivery of aid programs. Donors have become increasingly reliant on organizations like the Bangladesh Rural Advancement Committee (BRAC) and the Grameen Bank, which have shown themselves to be capable of managing large-scale programs and achieving measurable results on the ground. These organizations developed deeper and more reliable networks at the local level than some government agencies, and faced fewer political hurdles in carrying out programs. The option of working through NGOs also increased the bargaining power of the donors vis-à-vis the government. In 2012, for example, the World Bank cancelled a USD 1.2 billion project to build the Padma Multipurpose Bridge citing endemic corruption in government and by contractors. NGOs now absorb more than 30% of the country's aid flows and rising.

Aid flows are now less than two percent of GDP and declining. The reasons for the decreasing macroeconomic importance of aid relate directly to role of ODA in relaxing foreign exchange constraints (Figure 13). First, agricultural growth has accelerated dramatically since the 1980s, exceeding four percent per annum since the turn of the century. The growth of food production, almost entirely from increases in rice and wheat output, has reduced demand for imported food and food aid, which used to make up a significant proportion of aid flows. Self-

sufficiency in grains also conserves valuable foreign exchange, which can be used for other purposes.

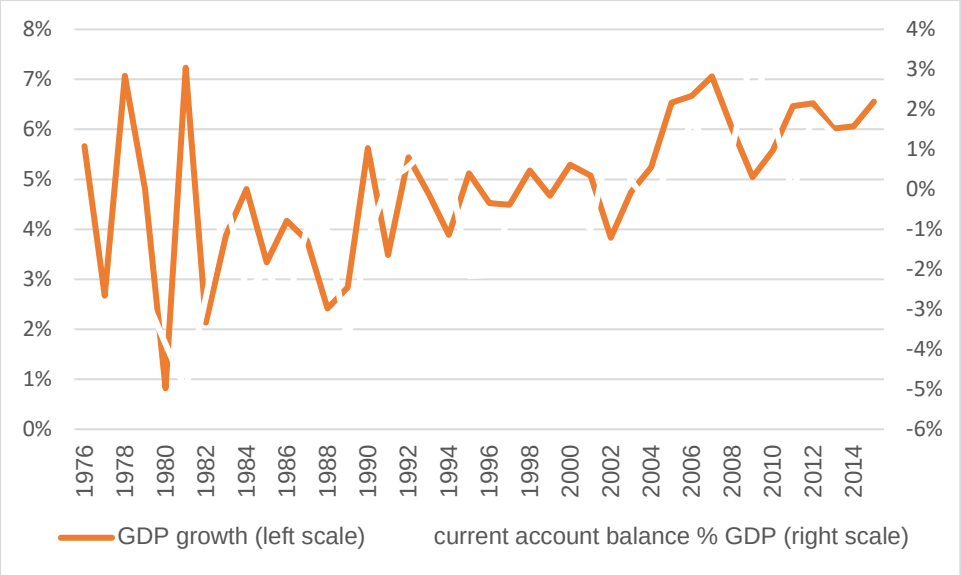

FIGURE 13. GDP GROWTH AND CURRENT ACCOUNT BALANCE, BANGLADESH

Second, the impressive growth of the garment industry since the 1970s has also gone a long way towards relaxing the foreign exchange constraint. The irony of Bangladesh's emergence as a major global producer of ready-made garments is that the original impetus for the industry was trade barriers imposed on developing countries. Korean manufacturers, who had used up their export quotas under the Multi-Fiber Agreement, relocated to Bangladesh to gain quota-free access to the US and European markets. Their success encouraged Bangladeshi producers to follow suit. By 2012 the garment industry employed five million workers and brought in 80% of the country's foreign exchange earnings.

Bangladesh is still a poor country, and with a GNI per capita of USD 1,330 in 2016. The country is still eligible for IDA loans at concessional rates. However, it is unlikely that aid flows will return to the high levels recorded in the 1980s and 1990s in view of the donors' increasing wariness of government and the availability of alternative sources of foreign exchange.

Indonesia

When the Suharto government came to power in 1966 its most pressing economic concern was an acute foreign exchange crisis. The country was essentially bankrupt and could not even afford to import essential supplies of food and fuel. The Intergovernmental Group on Indonesia (IGGI), an informal donor grouping that grew out of Paris Club debt renegotiations, promised generous infusions of grant and loan aid if Indonesia would agree to repay existing obligations and focus economic policies on growth to raise incomes and strengthen the country's capacity to repay debt in the future.

The origins of the aid program in a severe foreign crisis shaped the institutions and structure of fiscal management and the allocation of aid for the next thirty years. The government budget was divided into current spending (mainly salaries) and development expenditures. In the early years of the Suharto regime, ODA funded most of the development budget.

Underlying this unorthodox approach to budgeting was a deep fear of a recurrence of the hyperinflation experienced under the previous regime. In effect, the government imposed a balanced budget rule on itself, in which recurrent spending was set equal to tax revenue and capital spending was dependent on inflows of ODA.[8]

The onset of the oil boom (1973-1982) changed the composition of development spending but not its structure. ODA fell to 25% of the development budget, with oil revenues making up the rest. During the 1980s, when the world oil price fell and Indonesia again found itself facing chronic balance of payments problems, ODA rose to 80% of the development budget. But this episode was comparatively brief: a surge in manufactured exports in the early 1990s provided the foreign exchange required to reduce the role of aid in capital financing.

One of the most salient features of Indonesia's ODA flows is the dominant role of Japan. For many years in the 1970s and 1980s, Indonesia was the largest recipient of Japanese ODA, and Japan was Indonesia's largest donor. The relationship was of vital importance to both partners for many reasons, including a desire to move beyond the troubled history of Japan's wartime occupation of Indonesia, growing commercial relationships between the two countries and regional security concerns. Japan's preference for delivering ODA through discrete projects without a significant policy or technical component, and generally implemented by Japanese companies, suited the Indonesian government's aim of using ODA to fill gaps in the public investment budget. The concentration of aid originating from a one donor, using a simple, easily replicable modality, helped reduce the degree of fragmentation in the aid program.

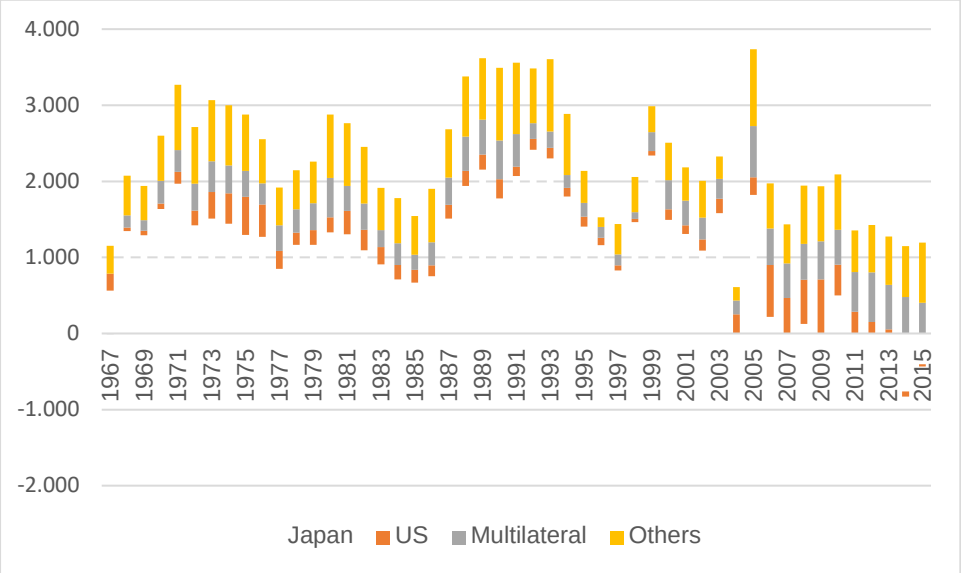

FIGURE 14. ODA FLOWS TO INDONESIA, CONSTANT 2009 USD (MILLIONS)

Another factor that reduced fragmentation in aid delivery was the role played by the economic "technocrats" based in the Ministry of Finance, the planning agency (BAPPENAS) and the Bank Indonesia. Known as the "Berkeley Mafia" (several of whom had studied at the

[8] Richard Robison, "Industrialization and the Economic and Political Development of Capital: The Case of Indonesia," in Ruth McVey, ed., *Southeast Asian Capitalists*, Cornell University Press, 1992.

University of California under Ford Foundation grants), this group of academic economists rose to power with President Suharto and retained control over economic policy, including the management of the aid portfolio, for the first two decades of the New Order regime. By the early 1990s, however, competing centers of economic and political power had emerged—notably the president's children and their burgeoning business empires—resulting in an erosion of their influence.

In terms of aid allocation, agriculture was the most important sector in the early years, driven by Indonesia's need to reduce food imports to conserve foreign exchange, and the need to raise incomes in the rural sector. Irrigation was particularly important, including several highly successful schemes such as integrated development of the Brantas River Basin, which eventually contributed about 25% of rice production in additional to flood control and power supply. Education and training grew in importance over time as agriculture declined, while Infrastructure routinely accounted for between 20 and 30% of ODA spending (Figure 15).

Aid was important to Indonesia during balance of payments crises, chiefly during the first five years of the Suharto government, and in the wake of the oil price collapse in 1983 and the East Asia financial crisis in 1998. ODA was directed to public investment through a unique system based on a separate development budget that was set based on the availability of external resources. Fragmentation was avoided owing to the coordinating role of economic ministers and the leading role of Japan as the largest donor.

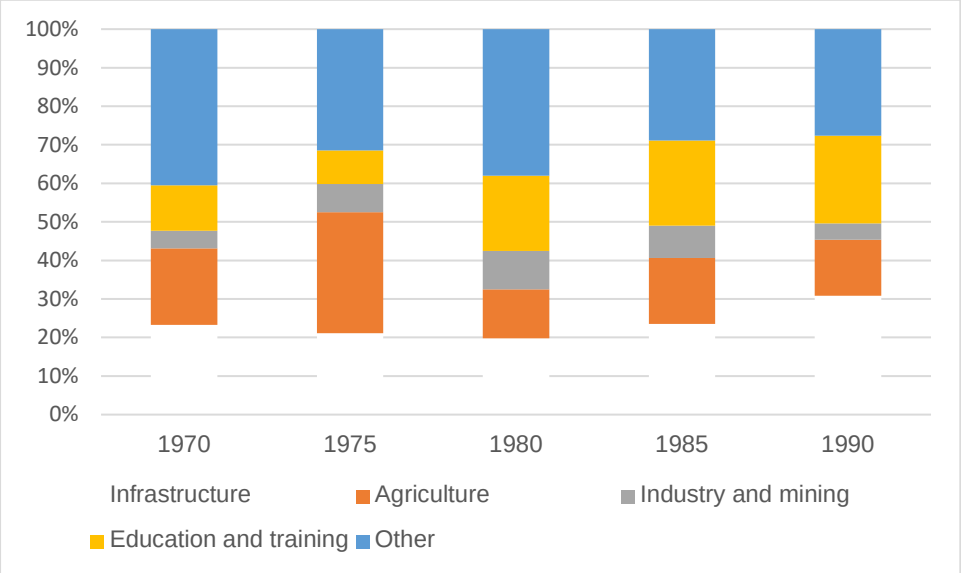

FIGURE 15. ALLOCATION OF ODA, INDONESIA 1970-1990

Viet Nam

Viet Nam has enjoyed reasonably stable and increasing access to ODA as Japan and the multilateral lenders have expanded their portfolios in the country (Figure 16). However, as a share of national income ODA has declined in important since 2000 and is now the equivalent of less than two percent of GDP (Figure 4). We can expect total ODA flows to decline in real

terms following Viet Nam's graduation in to the middle-income country club and loss of access to concessional loans from the multilateral donors.

A surprisingly small portion of ODA has been deployed in the agricultural sector (Figure 17), but this is partly a question of categorization as support for rural electrification is included under the energy category. Viet Nam's agricultural growth and emergence as an important food exporter has been a major factor in the country's economic success, raising rural incomes, providing cheap food to the growing urban labor force and earning foreign exchange.

Like Bangladesh, the importance of ODA to relaxing the balance of payments constraint has been reduced by the rapid rise in manufactured exports since 2000. However, the global crisis of 2008-2009 served as a reminder that foreign exchange can suddenly emerge as a major economic bottleneck, even in a country enjoying considerable export success. It is also the case the Viet Nam's exports—although growing rapidly—remain import intensive. Viet Nam still relies heavily on remittances to narrow current account deficits in some years.

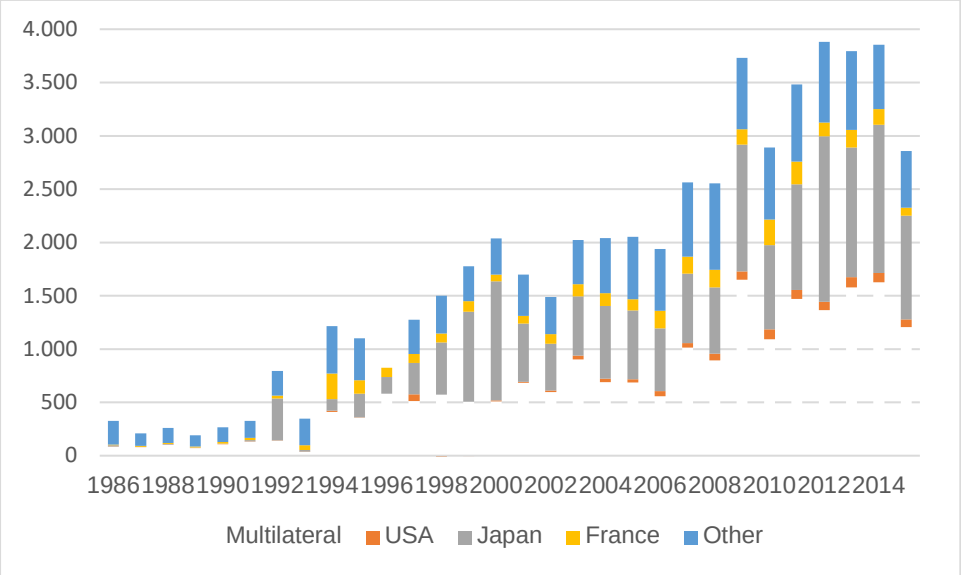

FIGURE 16. ODA FLOWS TO VIET NAM, CONSTANT 2009 USD

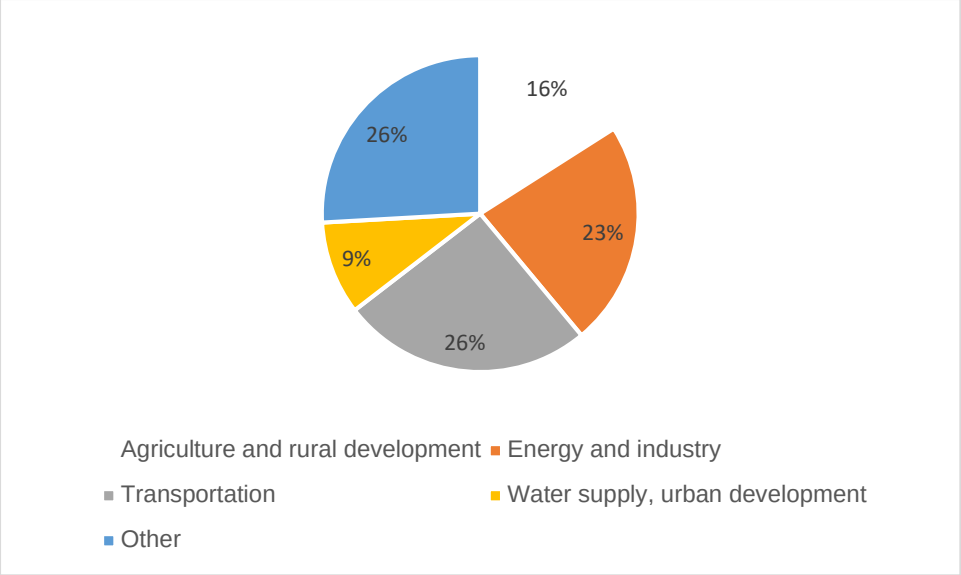

FIGURE 17. ODA TO VIET NAM 1993-2007, CURRENT USD

ODA flows to Viet Nam will continue to decline as a percentage of national income and most likely in real terms over the coming years. However, over the medium term we can expect climate change finance to make up an increasing proportion of official flows as donor organizations shift resources from poverty reduction to global public goods. The Green Climate Fund and similar mechanisms do not yet constitute a significant share of official transfers to Viet Nam, but this situation will change as multilateral and bilateral agencies refocus their strategies. According to the Intergovernmental Panel on Climate Change (IPPC), nearly one quarter of the population and one-eighth of land area is at risk, making Viet Nam is one of the most vulnerable countries in the world to climate change.[9]

Growth-enhancing Public Investment

A consensus has emerged among economists that the growth rate of the stock of public capital is positively associated with the rate of economic growth.[10] This means that indiscriminate or arbitrary public investment decisions that cut the rate of public investment can slow economic growth and reduce the government's long-term capacity to reduce its debt

[99] See Pamela McElwee, "Viet Nam's Urgent Task: Adapting to Climate Change," *Current History*, September 2017; and http://www.ipcc.ch/ipccreports/tar/wg2/index.php?idp=446.

[10] Some examples include: David Aschaeur, "Is Public Expenditure Productive?" *Journal of Monetary Economics*, 23:177-200; César Calderón Luis Servén, "Infrastructure, Growth and Inequality: An Overview," World Bank, Policy Research Working Paper 7034, September, 2014, http://documents.banquemondiale.org/curated/fr/ 322761468183548075/pdf/WPS7034.pdf; César Calderón Enrique Moral-Benito Luis Servén, "Is Infrastructure Capital Productive? A Dynamic Heterogeneous Approach," World Bank, Policy Research Working Paper 5682, http://documents.worldbank.org/curated/en/990231468331034266/pdf/WPS5682.pdf; Sanjeev Gupta, Alvar Kangur, Chris Papageorgiou and Abdoul Wane, "Efficiency-Adjusted Public Capital and Growth," IMF Working Paper Fiscal Affairs Department and Strategy, Policy, and Review Department, September 2011, https://www.researchgate.net/profile/Sanjeev_Gupta14/publication/228304631_Efficiency-Adjusted_Public_Capital_and_Growth/links/00463515710e64fcf5000000/Efficiency-Adjusted-Public-Capital-and-Growth.pdf.

burden.[11] Indeed, one of the reasons for the renewed focus on infrastructure is the finding that the collapse of public investment in the 1980s in much of the developing world acted as a brake on growth. This mistake was repeated after the recent global financial crisis in both advanced and middle-income countries.[12] In developing Asia, a clear relationship exists between public investment and GDP growth over the period 1990-2015 (Figure 18). The chart shows GDP growth (controlling for income per capita on the vertical axis, and government investment as a share of GDP on the horizontal axis (presented in logarithms). During this period a one percent increase in the share of government investment in GDP increased the rate of economic growth by about ten percent on average.

The Asian experience as described in the previous section lends support for the findings reported in these econometric studies. Countries that focused on *additions to the nation's growth-enhancing stock of public assets* have recorded higher growth rates. Moreover, countries that have experienced a decline in investment in public assets have experienced growth slowdowns. For example, in the wake of the East Asia financial crisis Indonesia was under severe pressure to reduce expenditures. For the period 2000-2007 public sector capital formation was 25 percent lower than the pre-crisis period (1990-1997). GDP growth during the later period fell by 33%. While other factors were in play, Indonesia's inability to regain levels of public investment recorded prior to the crisis was a principal cause of the long-term growth slowdown suffered during the post-crisis period. The relationship between investment in infrastructure and growth was recognized by the current government, which has made increasing the rate of public investment the signature policy of the new president's first term in office.

Indonesia is not alone in experiencing a long-term growth slowdown following a decline in public investment in response to fiscal contraction. An important consideration for Viet Nam as the government formulates new ODA directions is the impact of new fiscal rules on the rate of public sector capital formation. Within an overall framework of fiscal restraint, priority should be given to public investments that contribute to growth, since it is growth that will eventually deliver the revenue that the government needs to achieve a better balance in the public finances.

[11] William Easterly, Timothy Irwin, and Luis Serven, "Walking up the Down Escalator: Public Investment and Fiscal Stability," *World Bank Research Observer*, 23:1, Spring 2008.
[12] W.D. McCausland and I. Theodossiou, "The Consequences of Fiscal Stimulus on Public Debt: A Historical Perspective," *Cambridge Journal of Economics*, 40:4, 2016.

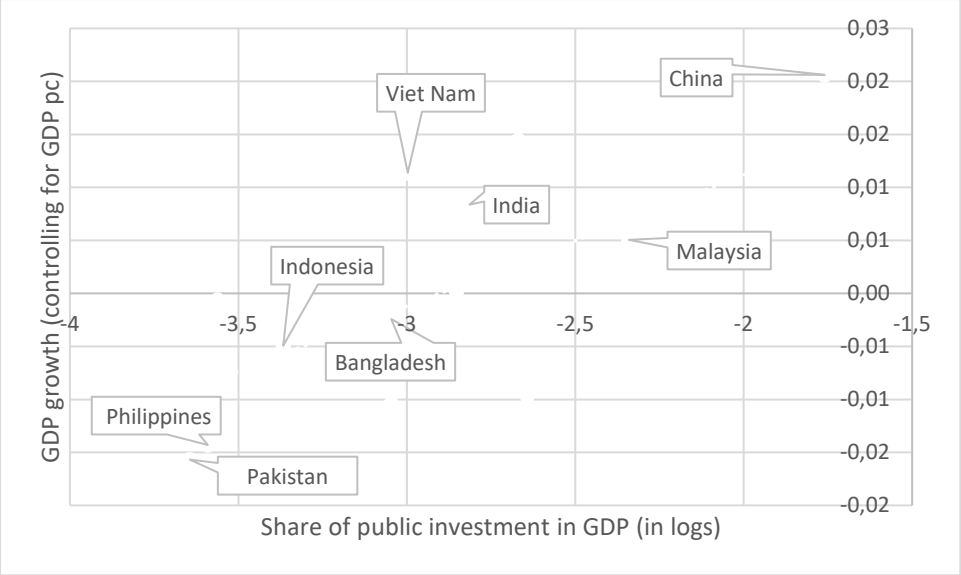

FIGURE 18. PUBLIC INVESTMENT AND GDP GROWTH 1990-2015, DEVELOPING ASIA (GDP GROWTH CONTROLLED FOR INCOME PER CAPITA IN 1990) SOURCE: AUTHORS CALCULATIONS FROM IMF CAPITAL STOCK DATABASE

Assigning priority to growth-enhancing public investment is not a straightforward matter. Feasibility studies will present estimates of return on investment, which is generally a good guide to economic impact. However, simply ranking projects by their benefit-cost ratios or internal rates of return may not yield the desired results. Other factors to the considered include:

- Critical infrastructure bottlenecks: Does the project eliminate a critical economic bottleneck that increases costs paid by businesses and consumers? Bridges are an obvious example: having to wait for ferries adds hours to journeys and the cost of transporting goods and people. A reliable power supply and irrigation are often constraining factors in manufacturing and agriculture. The development of water supply and sanitation systems in regions that have potential for tourism development with attract investment to these locations.
- Crowding-in private investment: Government investment is most likely to crowd-in private investment (in other words, raise the rate of return on private investment) when it is targeted at basic infrastructure, for example transport, power supply, water and sanitation and irrigation).[13]
- Spillover effects: Public investment generates various kinds of spillover effects. Network effects mean that investment in roads in one location increases the returns to road investments in neighboring provinces. Agglomeration economies (regarding supplier networks, technology, skills and infrastructure) provide justification for concentration of public investment in areas with greater economic potential. Although

[13] Luis Servén, "Does Public Capital Crowd Out Private Capital? Evidence from India," World Bank Policy Research Paper, no. 1613, 1996, (http://econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=469382&piPK=64165421&menuPK=64166093&entityID=000009265_3961214 130503).

this may have political costs (poorer provinces arguing that they need more help to catch up), the economic benefits of concentration are probably too large to be ignored.

- Affordability: Mega-projects attract the most attention and political support, but less expensive growth-enhancing investments should not be overlooked.
- Public goods rationale: Selected projects should have a clear public goods rationale. Projects that deliver a reliable revenue stream, and hence can attract private investment with a subsidy, should not be selected.

Some will argue that assigning priority to growth-enhancing projects is not sufficiently "pro-poor," as it does not require that the distribution of benefits should skew towards lower income groups. Two rejoinders can be offered. First, the policy decision to cap public debt as a share of GDP means that either public investment will have to be severely curtailed, or GDP will grow at a rate sufficient to enable the government to continue to invest. The option of high rates of investment at slow growth is no longer *politically* feasible.

Second, the evidence suggests that rapid economic growth since the 1990s has been pro-poor.[14] Growth of agricultural exports and labor-intensive industries have massively increased employment opportunities, especially among low-income and less skilled workers. While measured economic inequality has increased, it is still moderate in comparison with other countries in the region. Careful attention to the employment effects of public investment should ensure that the poor continue to derive benefits from public investment.

The Allocation Process

The objective of focusing scarce resources on growth-enhancing public investment can only be met if the allocation process of public investment resources is capable of ranking projects based on objective criteria and rigorous analysis.[15] To allocation process must apply to all public investment projects, including ODA projects and projects funded directly from government budgets, central and local government projects and PPP projects. The promise of external financing is not a sufficient reason to allow projects to circumvent the allocation process.

The apex of the allocation process is the Socio-Economic Development Plan and the Public Investment Program. As we have seen, countries that have utilized aid as part of a coherent development strategy have performed better than countries that have allowed public investment programs to be politicized and fragmented. Planning documents like the SEDP are often aspirational and not fully costed, and therefore do not provide an adequate basis on which to rank public investment projects. Project appraisal will help weed out projects that

[14] See for example, Paul Glewwe and Hai Anh Hoang Dang, "Was Viet Nam's Economic Growth in the 1990s Pro-Poor? An Analysis of Panel Data from Viet Nam," Economic Development and Cultural Change, 59:3, 2011; Nanak Kakwani and Hyun H. Son, "Pro-Poor Growth: The Asian Experience," UNU-WIDER Research Paper 2006/56, June 2006, https://www.econstor.eu/bitstream/10419/63301/1/514204206.pdf.

[15] For a summary of the literature, see: "Making Public Investment More Efficient," IMF Staff Report Report, June 11, 2015, http://www.imf.org/external/np/pp/eng/2015/061115.pdf.

do not deliver value for money, that impose excessive costs on vulnerable populations or the environment, or that have a high probability of underperformance or failure.

Yet in a world of scarcity it is likely that the capital budget is not sufficient to fund the full list of highly-ranked projects through to implementation. The planning and budgeting authority will be tempted in this case to select projects that have attracted ODA funding, while postponing projects funded from domestic resources. However, as this would effectively substitute the donors' preferences for the government's own criteria, and therefore is not a prudent basis on which to proceed.

The institutional set up underlying the public investment allocation decision-making varies from country to country and there is no ideal system that can be replicated in all contexts.[16] Nevertheless, coherent management of the process suggests that a single apex institution should take responsibility for investment allocation to ensure that projects that have passed screening (and are consistent with national, sectoral and local plans) are given equal treatment, and that fiscal rules are applied consistently. This apex institution must have the technical capacity to commission, conduct and utilize social-economic cost benefit analysis and the political capacity to carry out an unbiased ranking of projects based on objective criteria.

It is possible to identify at least five discrete steps in project allocation decision-making:

1. Development and Investment Planning: The government encodes its economic strategy in national planning documents, from which a public investment program can be specified. These are usually five-year documents that may be augmented by medium-term (three year) programs.
2. Project Identification/Initial screening: Line ministries and local authorities prepare project descriptions indicating the relevance of the project to national, sectoral and local plans and consistency with the Public Investment Program, the project's main objective, elements and activities, expected results and detailed budgets. Projects that pass initial screening will be consistent with national, sectoral and local plans and the Public Investment Program, address a priority need and fall within established capital budget limits. They will have a clear public objective that cannot be achieved through private actors without government support. Projects intended as PPP projects must assess the probably impact on government budgets and the level of private interest in the project concept.
3. Project appraisal: A rigorous process of project appraisal is required to estimate financial and economic returns to the investment (Figure 19). A technical feasibility study is required at the outset to review technical assumptions, evaluate the impact on the environment, and the likely effects of climate change on project implementation and outcomes. The next stage is financial analysis carried out in constant market prices. The resulting cash flow is discounted using the financial

[16] For useful international comparisons see Anand Rajaram, Tuan Minh Le, Kai Kaiser, Jay-Hyung Kim and Jonas Frank (eds.), *The Power of Public Investment Management: Transforming Resources into Assets for Growth*, World Bank, 2014.

opportunity cost of capital, which is the government's best estimate of the returns on alternative investments. If the project is profitable at market prices, the agency will focus on finding a private investor to undertake it, thereby conserving scarce public resources. If the project is not profitable at market prices but provides essential public goods, the appraisal can proceed to the economic analysis, which applies shadow prices to key inputs such as foreign exchange, and assigns economic values to non-market costs and benefits. The resulting cash flow is discounted at the social discount rate, which is the government's measure of the social opportunity cost of capital. If the project has a positive net present value the appraiser must conduct risk analysis to estimate the effect of changes in prices and other conditions on the project's economic rate of return. Pre-feasibility studies may be required for large and complex projects to avoid spending large amount of time and money on projects that are unlikely to achieve a positive outcome.

4. Ranking of appraised projects: The apex institution will maintain an inventory of feasibility studies and compile a ranking based on a clear set of criteria including economic rate of return, relevance to priorities articulated in national, sectoral and local plans and consistency with fiscal rules. Rankings may be based on individual projects or groups of projects (top priority, high priority, priority, etc.) but all projects slated for approval must be fully financed through the capital budget.
5. Independent review of high-ranking projects: Independent review is an essential step in the allocation process. The crucial consideration is the actual degree of independence of the review process: circulating drafts among ministerial counterparts (who may or may not have alternative projects on the vetted list) is a form of peer review but does not constitute an independent review. Independent experts from the university sector, think tanks, United Nations agencies and independent consultants are more likely to provide an unbiased assessment of feasibility studies and ask harder questions about the potential for less expensive or private sector alternatives.

6. Project selection and budgeting: Projects that pass through independent review are available for final selection based on the availability of budget and commitment to fund through to completion. Project selection should be based on a medium-term capital allocation plan that is ideally part of a unified budget (capital and recurrent costs) to ensure that sufficient funds are available to support project implementation through its conclusion, and to finance required maintenance during project operations. Approved projects that are not allocated budget are maintained in the government's inventory of feasible projects to be considered in the next budget cycle. Ratification of the list of selected and funded projects can include approval by the National Assembly (legislative branch), the Prime Minister (executive branch) or both.

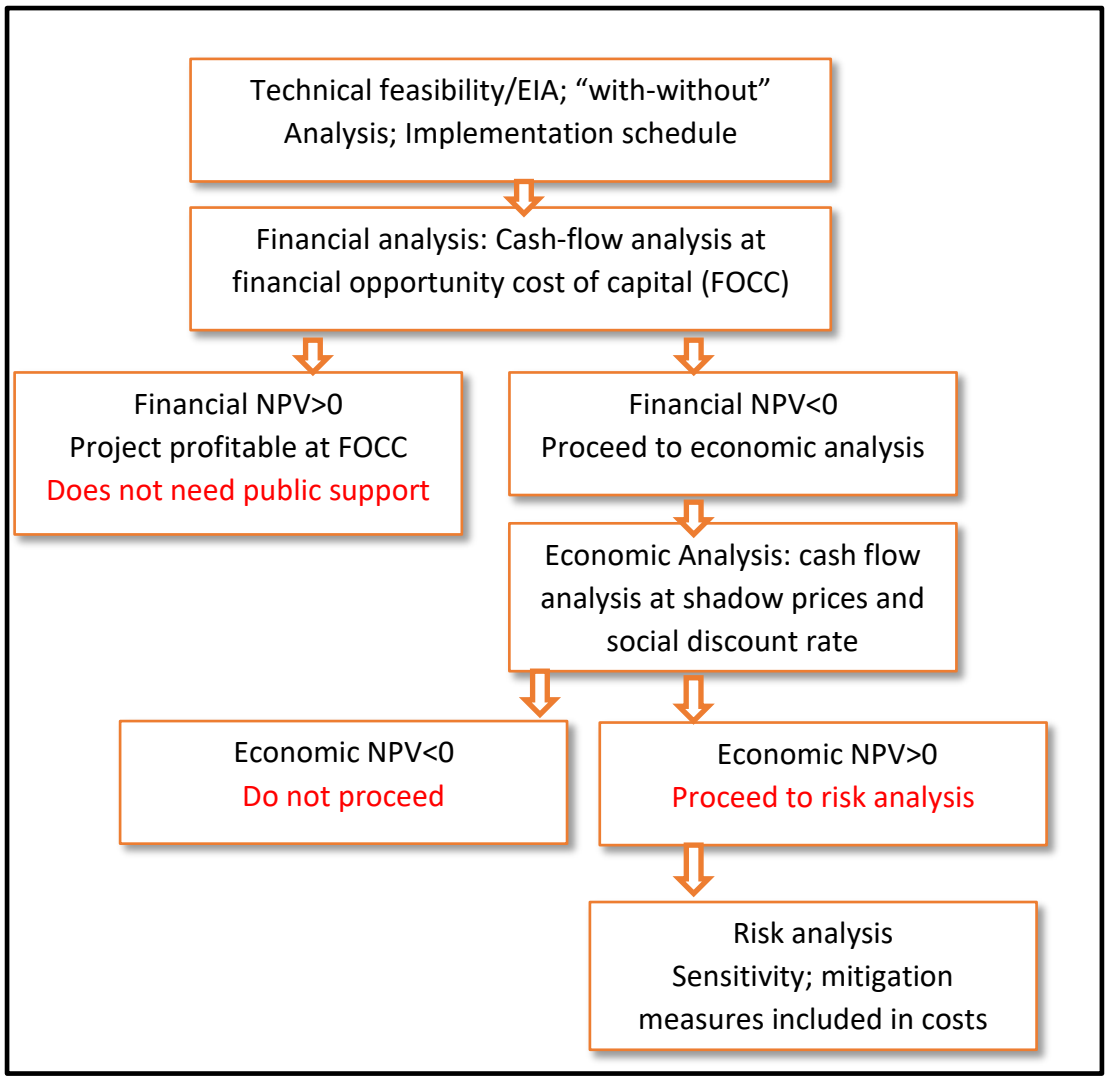

FIGURE 19. STEPS IN THE PROCESS OF PROJECT APPRAISAL

Publication of project appraisal documents, independent reviews and budget allocations by the apex agency facilitates transparency and public confidence in the selection of projects and the efficient use of public resources.

ODA and the Savings Gap

In this paper we have argued that from the macroeconomic perspective ODA is useful to the extent that it provides foreign exchange needed to acquire capital goods and technology in a context of balance of payments constrained growth. This runs counter to widely held belief that the main function of ODA is to close a savings gap that emerges because the domestic supply of capital is insufficient to finance the desired rate of investment. In fact, the savings gap and foreign exchange constraint are just two sides of the same coin. Current account deficits are *by definition* balanced by surpluses on the financial account, including net foreign investment and external borrowing. Capital inflows therefore raise the rate of investment above the level of domestic savings: but this is an accounting relationship, not a mechanism

that automatically moves toward equilibrium. There is no desired rate of investment that is established independently of the balance of payments that requires foreign savings to realize.

This point is illustrated in Figure 18, which presents Viet Nam's savings gap (gross fixed capital formation less domestic savings) and current account balance for 1996-2016. The savings gap widens sharply in 2007 as capital flows flood into Viet Nam on the wake of WTO accession. The rush of foreign capital drove up domestic asset prices, which stimulated pro-cyclical domestic investment, widening the current account deficit. With the onset of the global financial crisis, the government subsidized borrowing to replace external demand, which supported imports and investment. When the stimulus was finally removed, domestic corporations and households began to deleverage their debt positions, acting as net lenders for the period 2012 to 2016 (Figure 19). Figure 19 shows how the surge of capital inflows and pro-cyclical domestic investment destablilized Viet Nam's macroeconomy in 2007. In hindsight, the government should have taken action earlier to prevent the economy from overheating through some combination of interest rate rises, reduction in government spending and/or increases in taxes and curtailing the spending plans of state owned enterprises.

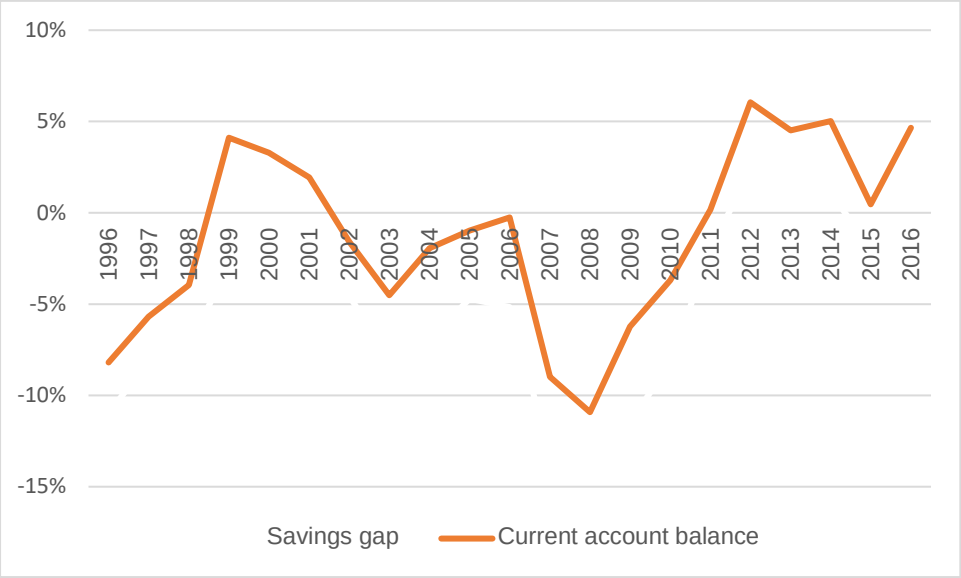

FIGURE 20. SAVINGS GAP AND CURRENT ACCOUNT BALANCE, VIET NAM (% GDP)

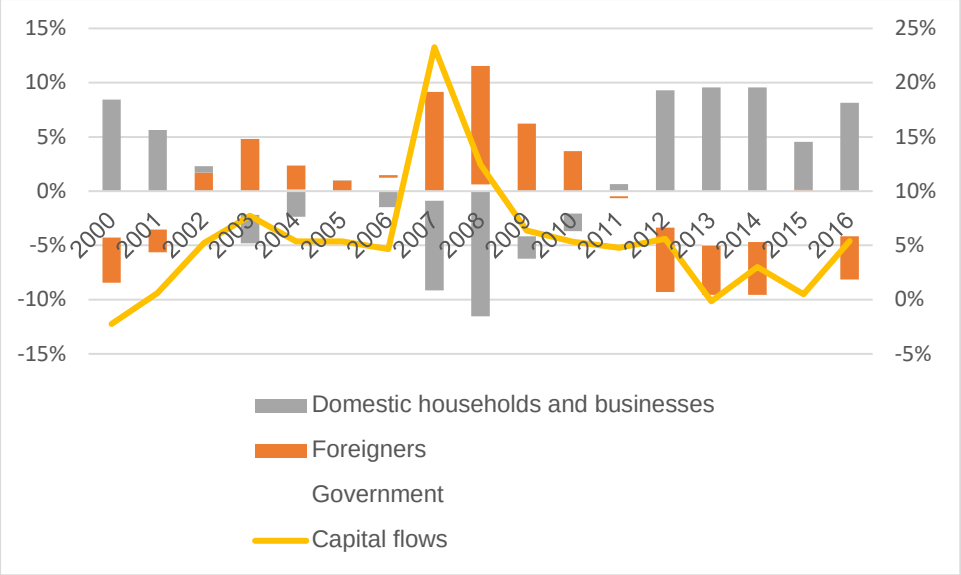

FIGURE 21. NET LENDING AND BORROWING AS SHARE OF GDP, VIET NAM

Since 2012, Viet Nam has recorded surpluses on the current account, and domestic savings have exceeded investment. Net lending from the domestic private sector (private saving) is now an atypically large share of GDP, although some of these savings are leaking out of the country as measured by the large errors and omissions recorded in the balance of payments.[17] On the face of it, there does not appear to be a savings gap that requires external financing.

If there is no savings gap, what is the use of ODA? One argument that is often put forward is that ODA provides concessional finance (lower interest rates) that reduce investment costs for the government. However, it is not necessarily the case that concessional loans translate into lower investment costs, or even if they do that this should be considered by the allocation process. This is because:

- External loans are often tied to the purchase of specific investment goods or technologies. The relevant financial consideration is the return on investment at market prices once all costs and revenues have been specified. On its own, the interest rate on loans is not an appropriate criterion.
- While the nominal interest rate on foreign borrowing is lower, foreign loans must be repaid in foreign currencies, and therefore entail foreign exchange risk. The difference between foreign and domestic interest rates reflects this risk, and in the long run we can expect real foreign and domestic interest rates to converge once movements in prices and exchange rates have been accounted for. There is not obvious benefit from borrowing in a foreign currency.
- Public investment projects that yield a positive net present value at market prices are usually not carried out by the public sector, as it should be possible to find a private investor who would be interested in implementing the project.

[17] Viet Nam does not publish flow of funds accounts that would enable us to separate out household, domestic corporations and banks. The purchase of government bonds by the banking sector to fund government deficits comprise a large portion of the net lending position of the private sector. Weak consumption growth figures suggest that householusds are also significant net savers.

- The decision to invest depends on the economic rate of return, valuing key inputs at economic (rather than market) prices and discounted using the social rate of discount. The interest rate offered by the donor is not relevant to the economic appraisal.

The nominal interest rate on external loans is less relevant to the viability of the project than the intended use of the loans. Given the absence of a savings gap, projects that do not require foreign exchange to import capital goods or new technology should in general not be financed by external loans, even if the loans carry lower financing costs than domestic borrowing. For example, financing agricultural extension projects using foreign loans should be avoided given that the project inputs are almost entirely domestic (training for local extension workers, construction of field offices and so forth). Conversely, investment in a railway line that requires importation of capital equipment should be financed by external loans, given that the main investment costs are paid in foreign exchange.

Criteria for selection of ODA projects

The role of official development assistance in Viet Nam's economy is changing. ODA is falling as a share of national income, and grant aid and concessional loans are being phased out in favor of loans at near-market rates. The National Assembly has established limits on the level of government debt in relation to GDP that effectively force the government to ration all borrowing, including ODA.

The government will therefore introduce criteria to use ODA more selectively. This paper has suggested several criteria for consideration in the government's new ODA directions, including:

- ODA should be directed to *growth-enhancing* public investments that increase the stock of public capital in ways that are supportive of economic growth;
- Projects that support export industries and activities should be favored, since they will help generate the foreign exchange that is required to meet future obligations resulting from foreign borrowing;
- The use of ODA should be restricted to investments that require foreign exchange for the importation of capital goods or technology, and should be used for projects in which all or almost all costs are domestic;
- ODA should not be allocated to projects that have a positive financial rate of return, as these projects can attract private investment and do not need a public subsidy;
- ODA should be allocated to projects that have a positive economic rate of return, in other words are expected to deliver positive net benefits to the nation once all costs and revenues are adjusted to reflect economic (as opposed to market) prices;
- Many projects that generate positive net benefits will relieve critical infrastructure bottlenecks that represent a brake on private investment because they increase the private costs of investing or doing business;
- ODA projects that crowd-in private investment—in other words, that increase the return on investment to private activities—should be given priority;
- Projects that crowd out private investment, for example that compete directly with private provision, should not be selected;

- Projects that generate positive spillover effects, for example network effects or agglomeration economies, should be favored.

Conclusion

The National Assembly and the Government of Viet Nam have made a policy decision to reduce the national debt relative to the size of the economy by 2030. Meeting this objective will require steps to broaden the tax base and reduce unnecessary spending. The public investment program, including ODA-funded projects, will be streamlined. This paper has set out a framework for the allocation of scare public investment funds under these conditions of scarcity for consideration as the government drafts its new ODA directions.

These policy changes come at a time when the role of ODA is changing in Viet Nam and globally. As a middle-income country, Viet Nam is no longer eligible for most concessional loans from official aid donors, and the volume of grant aid available to the country has decreased precipitously. ODA is now the equivalent of less than two percent of GDP, a figure that will continue to fall in the years to come. The fact that ODA will be less plentiful means that it must be used more selectively, and the process of allocating aid must be rationalized and made more transparent.

Global patterns of ODA are also changing. One and a half billion people now live in countries eligible for IDA lending from the World Bank. But 3.5 million people live in countries that have graduated from IDA lending, including Viet Nam. The problem of poverty has not been solved, but increasingly poor people live in middle-income (and rich) countries. It will become increasingly difficult to ignore the fact that poverty is not confined to low-income countries.

As the number of extremely poor countries falls, donors will increasing turn their attention to financing global public goods, for example adaptation to climate change, the transition to cleaner energy, deforestation and biodiversity, infectious diseases and HIV/AIDS, the management of migration and refugee populations and security concerns. New mechanisms like the Green Climate Fund will be created, and the dividing lines between official ODA and private sector initiatives will become less distinct. These changes will have important implications for Viet Nam, which is well-positioned to take a leadership role in issues such as climate adaptation.

The paper has argued that the government should prioritize growth-enhancing projects. A consensus has formed around the idea that efficient public investment is crucial prerequisite to rapid economic growth. For developing Asia, raising the share of public investment in GDP by one percent was associated with a ten percent increase in the rate of growth over the period 1990-2015. The fact underlines the importance of public infrastructure in creating the conditions for growth and indicates that sharp reductions in public investment—as occurred during the period of structural adjustment in the 1980s and in the wake of the East Asia financial crisis—can have pronounced, long-term negative effects on growth.

Increasing the efficiency of public investment is equally important. Improving the governance and transparency of the decision-making process is needed to reduce the influence of political

factors in decision-making. In addition, investment projects that have the potential to attract private investment should not be undertaken by the public sector. Projects that crowd-in private investment, that resolve critical bottlenecks and generate spillover effects should be prioritized.

The paper has focused on the institutional set-up for the allocation of public investment and some specific criteria for allocation. The process of selecting public investment projects needs to be made more transparent and should stress objective indicators rather than political considerations. The use of independent assessment should be enhanced. It is important that the selection of public investment projects is undertaken based on a rigorous process of capital budgeting and project appraisal.