PROJECT VERSUS PROGRAM AID: FROM THE DONOR'S VIEWPOINT

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H. W. Singer has recently re-opened one of the longest standing controversies in the administration of foreign aid, the question of project versus program aid.[2] Unfortunately, his analysis is limited largely to the much discussed fungibility issue.[3] While this is an important issue, it is far less so than Singer's treatment implies. As will be brought out later, there are even some major aid recipients, such as India, where it is not a major problem. Singer's conclusion, that there is something to be said for both types of aid, has some merit, but is inadequately supported by the remainder of the paper. This is almost entirely concerned with pointing out some (but by no means all) of the problems with project aid. Little is said concerning the drawbacks of program aid. In brief, the project-program question is just much more complex than Singer suggests. Before attempting to bring out these added complexities, it is useful

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[1] Due to the interaction that has occurred between a number of RAND staff members engaged in studying the allocation and administration of foreign assistance, it is difficult to fully separate individual viewpoints. I am particularly indebted, however, to Robert Slighton of RAND for permission to use a section of an earlier joint study and for his helpful suggestions, and to William Johnson, Richard Nelson, and Charles Wolf, Jr., of RAND for their detailed comments. I am also indebted to Joel Bergsman of the University of California, Berkeley contract staff in Brazil for his comments on an earlier version.

[2] H. W. Singer, "External Aid: For Plans or Projects?" Economic Journal, Vol. 75, No. 299, September 1965, pp. 539-545.

[3] See, for example, Thomas C. Schelling, International Economics, Boston, Allyn and Bacon, 1958, especially pp. 441-457. Fungibility will be discussed in more detail below.

to make several initial distinctions that set the problem in a more meaningful context.

The most basic of these distinctions is between the interests of the aid donor and the recipient. Singer addresses the project-program question with an implied recipient country welfare function. This gives rise to the question of whether the donor or recipient government knows what is "best" for the recipient country. But much more important, it ignores the fact that the form of external assistance is determined largely by the donor rather than the recipient. An attempt to either understand or influence the choice between the two approaches can much more usefully examine the donor's point of view.[1] Perhaps the least interesting point of view is that of the recipient government, which will almost always prefer program aid because of the increased flexibility it confers.

Once it has been decided that the relevant viewpoint is that of the donor, a related distinction arises between the domestic political motivations of the donor for the two types of aid and his objective reasons for adopting them in terms of his national (or institutional) self-interest.[2] Here the interesting question from an economic standpoint is which approach would be more suitable if the donor's domestic political considerations are ignored.

Before examining the relative merits of the two alternatives, it is worthwhile clearing up another source of confusion on the subject

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[1] Although this paper assumes that the donor's primary objective is to promote the recipient's economic development, many of its conclusions are applicable either directly or with minor changes to aid given for other objectives, such as increasing the recipient's military capability or compensating him for foreign military installations on his soil.

[2] One of the strongest reasons for the continued partial use of the project approach by the United States Agency for International Development is undoubtedly the strong support for this type of assistance in Congress. This support is to a considerable extent based on the identification of project aid with traditional banking activities. The project approach of the International Bank for Reconstruction and Development may also be partly motivated by the conservative image that it helps to create in financial circles.

-- the definitions of the terms involved. Project aid can be defined as assistance whose disbursement is tied to capital investment in a separable productive activity. Program aid is assistance whose disbursement is tied to the recipient's expenditures on a wide variety of items justified in terms of the total needs and development plan of the country rather than any particular project. The important distinction is that project aid carries added restrictions on its use. Because aid has usually been project-tied where possible, program aid has become identified with aid not nominally used in investments in productive activities, or, in other words, with that used for maintenance imports. Nevertheless, there is an important conceptual difference and sometimes a practical difference between program aid and aid used for maintenance imports. It is quite possible, for example, to supply free foreign exchange (such as would be likely to be used for maintenance imports) with project aid.[1]

It is often difficult to classify some capital assistance, particularly that given by the United States Agency for International Development (AID), as either project or program. Thus AID has given substantial assistance to meet the foreign exchange needs of the Indian Railways. Although most of this assistance is tied to foreign exchange expenditures for a number of different Railway capital projects, AID has made little effort to document the returns from each particular project,[2] even though such loans are considered project loans to India. They are really program loans to the Indian

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[1] The procedure is to tie the aid (assumed to be in the form of foreign exchange) to more than the foreign exchange costs of projects. Part of such local cost financing will, of course, only serve to cover the increased imports indirectly resulting from the local currency expenditures. But the remainder (if any) will amount to a net increase in the foreign exchange available for other purposes. This remainder is not entirely hypothetical since the International Development Association has on occasion supplied a significant amount of free exchange in connection with some projects in India and perhaps elsewhere, while AID has done so in some Latin American countries.

[2] This paragraph is based on Alan Carlin, "An Evaluation of U.S. Government Aid to India" (unpublished doctoral dissertation, Massachusetts Institute of Technology, 1964), pp. 47-137.

Railways for capital projects of their choosing, and are justified on the basis of the overall performance and needs of the Railways. Another example of assistance in the gray area between project and program aid is aid to intermediate credit institutions.

With these definitions in hand, it is possible to reformulate the original question somewhat more precisely. The objective of this paper is to set out the more important considerations that a rational donor should take into account in deciding whether it is more advantageous to give aid as project or program assistance. Since project assistance can be considered program aid with certain additional restrictions on its use, a convenient way to review the arguments on each side is by looking at the additional benefits and costs of these added restrictions.

BENEFITS OF THE PROJECT APPROACH

The more important potential benefits[1] of the project approach are:

1. Direct control by the recipient over the selection of projects under certain circumstances

2. Greater opportunity to influence, in both their design and implementation, those projects nominally financed by the aid donor

3. Increased ease of influencing the recipient's policies in those sectors of the recipient's economy for which project aid has been made available

4. Incentives for improving the quantity and quality of projects

5. Better opportunities for publicizing the donor's aid programs

6. Increased access to information on sectors of the recipient's economy in which projects are financed

7. If aid is also tied on a country-of-origin basis, a somewhat less adverse effect on the balance of payments of the donor nation.

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[1] Throughout the paper the discussion of benefits will be in terms of potential benefits. Since donors vary greatly in the extent to which they actually achieve these benefits, it is best to discuss the optimum case and allow readers to apply their own discounting factors for the donor in which they are interested.

Micro-influence

The first three benefits are related and involve the exercise of micro or project influence over the recipient. As many have pointed out, the fungibility problem greatly limits the effectiveness with which project controls can influence the recipient's allocation of resources. The fungibility problem arises because the particular project with which the aid is identified may or may not represent the actual use of the added funds provided by the aid.[1] This problem has often been overemphasized by economists, however, since there are a variety of circumstances under which influence can be exercised over the allocation of resources despite it. One such case arises when the donor offers aid for a project that the recipient regards as sufficiently marginal so that he would not finance it out of his own resources if the aid were not made available. This means that if the donor can find what he considers worthwhile projects neglected by the recipient, he can influence the recipient's allocation of resources. Despite Singer's doubts on the subject, a number of aid donors have been able to identify marginal projects when they have set out to do so. In the early 1960s, for example, the International Development Association attempted to locate a number of such projects in India, and chose projects in the areas of highway development, telephone service, irrigation, and drainage to receive credits.

In the extreme case, all of a donor's projects can be considered marginal, and he can effectively determine the recipient's allocation of investment resources provided through project support. This occurs when the recipient's free foreign exchange resources are already tied down to uses given relatively high priority by the recipient while not including any of the projects financed by the donor. If no foreign private or public investment body is willing to finance a

[1] Thus, although expenditures for imports for a power plant may be reimbursed by the aid donor, the plant might well have been built even if total aid had been reduced by the amount reimbursed. The funds can then hardly be said to have financed the power plant at all, but rather the use of the funds that would have been sacrificed if the aid had not been extended.

given project, the country must usually abandon it. This situation occurs most commonly when the recipient country cannot meet all of its essential "maintenance imports" out of its own foreign exchange holdings or earnings. India provides a good illustration within recent years. Her debt repayments and imports of food, essential consumer goods, and raw materials needed to keep existing industrial capacity in production exceed her free foreign exchange. Failure to meet the more basic of these requirements would have worse political and economic repercussions than failure to expand capacity, so that it is probable that the latter would be sacrificed should India have to choose between the two. As a result, the use of project aid can substantially influence the allocation of India's developmental resources. As long as the sum of available free foreign exchange plus untied program aid is less than essential maintenance imports, no project requiring substantial amounts of foreign exchange will normally be undertaken without some public or private international financing.

India's efforts to find a donor for its seventh steel mill (fifth in the public sector) illustrate the point involved. Since she has been unable to find a donor, the project has been delayed for lack of foreign exchange. Current Indian thinking centers on one possible loophole in the donor's ability to influence India's resource allocation, namely, the possibility of financing the project through short-term supplier's credits arranged by a consortium of foreign equipment suppliers with maximum reliance on domestically produced equipment. But given a determination by the aid donors to avoid such an end-run, which could ultimately only be financed through larger program loans, this loophole should not prove impossible to close.

Besides enabling the donor to exercise some influence over the recipient's allocation of resources, at least in some cases, the use of project aid also enables the donor to more easily influence the projects nominally financed, whether or not they happen to be the projects that the aid actually makes possible. If the donor's goal is the recipient's economic development, this influence will presumably be directed towards improving the economic viability of the projects. The influence can be exercised in a number of ways, particularly by insisting on higher standards of project preparation, by introducing technical aid as part of the project, by imposing various conditions on the execution of the project, or, in the extreme case, by partial supervision of the project itself. Much more than capital is usually needed by less developed countries. In many cases technical aid and other influences do more than improve the economics of a project; without them, the project may not be economically viable.

One striking example is provided by the contrast between the steel mills erected in India in the late 1950s with British and German assistance and that erected with Russian aid. The markedly superior performance of the Russian-built mill (Bhilai) in the years following its completion can be ascribed in considerable measure to the close and constant supervision and aid furnished by the Russians after the mill went into operation.[1] The British and Germans did not insist on such supervision because of Indian reluctance to accept it. Not until the mills they built deteriorated to such a point that they became national issues did the Indian government and the foreign equipment suppliers agree to meaningful foreign participation in the direction of the mills.

Investment in physical capital is only one essential requisite of industrial growth; it is also necessary to develop various skills, particularly managerial skills, to use the capital efficiently once it is built. Capital projects are an effective way to provide this form of technical aid. Most LDCs are reluctant to admit that such aid is vital to the success of many projects; project aid provides the donor with some leverage to insist that it is accepted.

In addition to making possible the exercise of greater influence on the allocation of resources between projects and on individual

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[1] See William A. Johnson, The Steel Industry of India, The RAND Corporation, Chapter 8, forthcoming.

projects, the project approach also opens up opportunities for exercising greater influence on policies in sectors related to the projects nominally financed by the aid than would be possible with program aid. This can often be done by arguing that changes in these policies are necessary for the success of the project. For example, in the case of a railroad project, the donor might be able to insist on changes in the railroad's rate structure, or in the case of a fertilizer plant, a change in fertilizer prices or distribution practices.

Unfortunately, much of this section on the benefits of micro-influence has had to be rather general because of the few examples available of its effective use. One of the major conclusions of an earlier study of the U.S. aid program to India was that little micro-influence has been exercised through project restrictions on capital aid.[1] Although AID and IBRD projects in India appear to be worse in this respect than the average in other countries, the difference does not appear to be very great, particularly with respect to influencing policies not directly related to aid projects in sectors for which aid has been made available. Recently, however, the IBRD has shown what can be done in the way of significantly improving the design of a project by insisting on an improved project report on the proposed Haldia port in India. Since the benefits from exercising micro-influence are undoubtedly the most important potential benefits of project lending, their frequent absence in practice greatly diminishes the case for the project approach in those cases. It is certainly not an easy task to create an organization sufficiently competent to exercise much useful influence. Those donors that are unable to do so should certainly seriously question the wisdom of pursuing the project approach.

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[1] See Alan Carlin, op. cit., pp. 232-234 and 241-242. The study includes detailed analyses of U.S. aid to Indian irrigation and transportation and the extent of micro-influence through it.

Other Benefits

One important but largely overlooked potential benefit of project lending is the incentive it can provide for recipient countries to develop a larger number of acceptable projects than they otherwise would.[1] This is desirable not only because of the favorable economic effects of the additional projects that may be engendered, but also because it provides, to some extent, a meaningful measure of the recipient's performance and "absorptive capacity" as an objective guide[2] to donors in setting country aid levels. As long as there is a relationship between project approval and project preparation, the country that is able to increase its generation of acceptable projects can increase its share of the available funds. This can provide a significant built-in incentive to recipient countries in marked contrast to program aid, where the incentives normally work in the opposite direction since the larger the balance of payments or budget deficit (the usual criteria, in the absence of any objective criterion of performance), the larger the aid. While it might be possible to impose conditions on program aid dealing with the number and acceptability of available projects, this type of incentive can be more efficiently applied by the use of project aid in the first place. Experience also suggests that there is indeed ample opportunity for many aid recipients to substantially increase their total aid receipts by increasing the number and quality of projects they prepare. There are a number of countries (such as India) where pledges of project assistance by various aid givers have gone unused because the potential

[1] This is not to say that all aid donors have given or are likely to give project aid in a way that will always provide such incentives. In many cases there are significant administrative and political pressures to maintain previous levels of assistance to particular countries, with the result that project standards suffer.

[2] This is not meant to imply that the level of aid suggested by the availability of acceptable projects is "optimum" (say in terms of minimum discounted total cost to the deonors to achieve some development goal), but that it is not (or at least less) influenced by considerations other than the economic performance of the recipient.

recipient fails to come up with an adequate number of acceptable projects. The use of project assistance can have an important educational effect by emphasizing the importance of developing this often neglected but critical capability.

The added publicity value derived from identifying aid with particular projects (which might be terms the "billboard effect") can be of importance. The Russians, for example, appear to place considerable emphasis on this gain from project lending and have used it with unusually good effect. By identifying their aid with certain prominent or "impact" projects in a number of countries, they have greatly increased the publicity value of their aid.[1] The best known examples are the Bhilai and Bokaro steel mills in India, the Aswan dam in the United Arab Republic, and the Kabul street paving project in Afghanistan. Clearly project aid, especially if attributed to such carefully chosen projects, greatly increases the publicity value of the donor's aid.

Still another potential benefit of project aid is that it often provides the donor with an opportunity to obtain detailed information concerning at least the principal techno-economic problems of the sectors in which the projects are located. Because of both the association of aid financing with bank financing and the desire of the country to receive the aid, it is often possible, with a minimum of hard feelings, to use the project application as an excuse for obtaining information not only about the project itself but also about related activities. This can be useful for suggesting specific conditions to attach to the approval of the project that will improve the efficiency of the sector concerned. It can also be useful in analyzing in greater detail the development prospects and performance of various sectors, which can, in turn, form the basis of a more general analysis of the development prospects of the country, and, therefore, the desirability of giving it aid in the first place.

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[1] By way of illustration, most people are surprised to learn that the Soviet Union has contributed less than 6 percent of total aid utilized by India from 1950 through 1963, and ranks as the fifth largest donor.

With country-of-origin tying, as in the case of AID loans, the addition of project restrictions to aid generally results in a larger net increase in the donor's exports per dollar of his aid than in the case of program aid. This, in turn, will mean that project aid has a somewhat less adverse effect on the balance of payments of the aid giver per dollar. Although the recipient usually suggests that aid be nominally ascribed to projects where the largest percentage of imported goods would be purchased from the aid giver if the project were financed from free foreign exchange, it is likely that a somewhat lower percentage of the goods purchased under a project loan would have been purchased from the aid giver in any case compared with the purchases under a program loan. It is not usually possible to find projects that consist entirely of goods normally or most advantageously purchased from any one donor country. On the other hand, from a long list of maintenance imports, from apples to oil, it is fairly simple for the recipient to pick out those goods that would normally be purchased from the aid giver anyway.

It has often been alleged that the project approach is also less likely to lead to a "politically frozen" aid level. A program aid level maintained over several years can take on a political status that makes for inflexibility. In contrast, project aid is at least theoretically tied directly to the submission of eligible project proposals by the recipient government. Either slow submission of good proposals or slow utilization of funds already obligated will automatically result in lower assistance levels, besides signalling inadequate performance by the recipient country.

COSTS OF THE PROJECT APPROACH

The potential costs of project aid can be grouped into the following categories, roughly in the order of their importance:

1. Possibility of reduced leverage over aggregate policies of the host country

2. Introduction of incentives favoring the construction of new capacity rather than providing raw materials that would make it possible to better use existing capacity

3. Intergovernmental problems arising from the bureaucratic frictions created by detailed supervision of project formulation and execution

4. Increased costs of aid administration

5. Increased real cost (to the recipient nation) of borrowing.

These costs are likely to be present even where the technical expertise and administrative efficiency associated with project aid are beyond reproach. An additional set of costs emerge if there are administrative or analytical failures on the part of the aid giver. Since it is doubtful that any organization can avoid all mistakes, costs in this second category ought also to be considered. In particular these are likely to arise from delays in the recipient's capital projects as a result of review and supervision by the donor, as well as in categories (3) and (4) above.

Many of these costs also depend in magnitude on the assiduity with which the aid giver attempts to exercise influence over the recipient. There are no costs in terms of macro-bargaining opportunities forgone if no bargaining would be attempted anyway and few costs if no attempt is made to exercise project influence. Costs arising from the frictions involved in project scrutinization will be unimportant if the review of project proposals and the monitoring of project implementation is largely permissive. Assuming away the problem of creating an effective control system, the most important potential cost of giving aid in the form of projects is the loss of bargaining power over aggregate economic and political policies of the borrower. The intergovernmental _cum_ interbureaucratic frictions of effective project control are chiefly important because they result in an erosion of host-country willingness (and ability) to agree to restrictions on its freedom of action implied by aggregate performance criteria.

To the extent that project aid reduces the potential leverage per dollar of aid over broader policies,[1] this is indeed an important

[1] If the donor's objective is the economic development of the recipient, the donor will often be most interested in affecting fiscal and monetary policies.

consideration. Such a reduction might occur for two reasons. First, project aid may be worth less to the recipient government, especially if there is a squeeze on maintenance imports. Secondly, any attempt to exercise micro or project influence will tend to further decrease the attractiveness of the aid to the recipient and hence the potential macro-leverage available per dollar. It should be pointed out, however, that the use of macro-leverage on the LDCs has been something less than wholly successful to date. Despite increasing interest and efforts in this direction in the early 1960s, it has been used successfully only in one or two cases in the last decade. The problems arise mainly because of the administrative difficulties of making the criteria meaningful and the political difficulties of making conditions effective.

It is assumed here that it is quite possible to exercise macro-influence with project aid, preferably by bargaining over groups of projects or project packages. Given this, it can be argued that to some extent micro- and macro-influence exercised through project assistance are complements rather than substitutes for each other. In fact, a considerable portion of the benefits from project level influence can be obtained without the recipient feeling that he has been asked to make a major concession that greatly decreases the value of the aid. To a considerable extent this influence is quite similar to technical aid -- suggestions for relatively minor improvements in a project or its operation, or perhaps insistence on certain standards in project submission and preparation. In addition, attempts at micro-influence can be partly justified by the "normal" banking practice of attempting to insure the credit-worthiness of a given project and hence may not be considered as great an interference in the internal affairs of the recipient country as it might otherwise.

Project aid undoubtedly introduces a number of biases into country development. Perhaps most important, it favors building new capacity rather than making better use of existing capacity. Since project aid is often more readily available than program aid, there are built-in incentives for the potential recipient to accept additional project aid even if his resources could be better devoted to fuller utilization of present capacity. The result is likely to be overbuilding of infrastructure and expansion of the public sector. Once again perhaps the best example is India. Because her free foreign exchange and non-project aid receipts are less than her non-project needs, there is considerable underutilization of industrial capacity. Yet she continues to accept project-tied aid to build new industrial capacity, some in the same industries now suffering from a shortage of maintenance imports.

Even if project influence is inherently more palatable than program influence, project assistance may also give rise to a number of interbureaucratic frictions, often of the most non-substantive, petty type. These sometimes arise in the case of AID because of a number of specific prohibitions written into foreign aid legislation by Congress.

The real costs of loans to the recipient may be increased by the project approach in the case of country-tied aid from individual countries for the same reason that the foreign exchange costs to the aid giver are reduced -- the recipient is forced to buy some items for a given project from a country other than the lowest cost producer. If the objectives of the donor include a concern for the economic welfare of the recipient, this may represent a cost to the donor as well.

CONCLUSIONS

The general conclusion from this analysis, that there is something to be said on both sides, is much the same as Singer's. But unlike Singer, it is important to stress that the particular objectives of the donor in giving aid and to some extent the particular circumstances of the recipient are likely to make it advisable to pursue a project approach in one case, a program in another, and some combination in still others. This paper has attempted to outline what some of the more important considerations are. Undoubtedly the most important of these is whether the objectives of the donor can be best served by attempting to exercise influence on the macro- or the micro-level.

Although micro-influence can result from program aid and macro-influence from project (properly "packaged"), such influence is usually more effectively exercised by project and program aid, respectively. The primary question is the level on which influence can most usefully be focused; the choice of type of aid is generally a second-order issue that follows from the first.

If, for example, the donor's objective is the recipient's economic development, and the donor believes that it is by influencing project preparation and execution and related sectoral policies that he can most fruitfully use the limited leverage provided by his aid then the project approach would be preferable. If, on the other hand, the donor believes that his objectives can best be served by concentrating his influence on broader, more aggregate issues, program aid offers some advantages. If some mixture is desired in the direction of donor influence, project aid can be "packaged," with emphasis on macro-bargaining over the packages.

There are other considerations in selecting one or the other aid instrument besides the relation of donor objectives to the optimum level of influence. Another, for example, is the competence of the donor in exercising influence through project aid. In general, there are a number of factors to be taken into account in each donor-recipient relationship, and it is a question of weighing one against the other. The significant aspect of this (and Singer's) conclusion is that it differs markedly from the prevailing view of many economists that program aid is to be preferred. All too often this judgment is based solely on the fungibility argument, which is but one of several important considerations to be taken into account.