Do Pacific Countries Receive Too Much Foreign Aid?

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The Aid Effectiveness Literature

• Focused on evaluating the impact of aid on growth
• The impact of aid varies but - on average – it spurs economic growth in recipient countries
• However, the impact of aid on growth is subject to diminishing returns
• Implication is that there are limits to the amounts of aid that recipient countries can absorb effectively
The Contribution of Aid to Growth

\[ \text{Growth}_i \]

\[ a_i^* \]

\[ \text{Aid/GDP}_i \]
What Causes Diminishing Returns to Foreign Aid?

• Human capital constraints
• Policy/institutional constraints
• Macroeconomic
  – Real exchange rate appreciation / export competitiveness
• Infrastructure
• Poor donor practices
When Do Diminishing Returns to Aid Occur?

Studies indicate that diminishing returns sets in when aid accounts for approximately 20 per cent of a recipient’s GDP.
Important Message......

• Absorptive capacity constraints do NOT imply that donors should stop scaling up their aid programs

• The global aid budget would need to increase to US$1,466 billion to account for 20 per cent of GDP in all developing countries

• But – it’s important to get the allocation of aid across countries right
How Much Aid do Pacific Countries Receive?

<table>
<thead>
<tr>
<th>Country</th>
<th>Ratio of ODA to GDP (%) 2005-08</th>
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</thead>
<tbody>
<tr>
<td>Fiji</td>
<td>1.7</td>
</tr>
<tr>
<td>Kiribati</td>
<td>22.9</td>
</tr>
<tr>
<td>Marshall Islands</td>
<td>37.1</td>
</tr>
<tr>
<td>Micronesia, Fed. Sts.</td>
<td>42.4</td>
</tr>
<tr>
<td>Palau</td>
<td>19.9</td>
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<tr>
<td>Papua New Guinea</td>
<td>4.8</td>
</tr>
<tr>
<td>Samoa</td>
<td>8.9</td>
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<tr>
<td>Solomon Islands</td>
<td>42.4</td>
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<tr>
<td>Tonga</td>
<td>9.3</td>
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<tr>
<td>Tuvalu</td>
<td>51.2</td>
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<tr>
<td>Vanuatu</td>
<td>11.5</td>
</tr>
</tbody>
</table>
Conclusion/Policy Responses

• Donors must examine closely the levels/impacts of their aid to seemingly ‘over-aided’ countries

Options (other than reducing aid) include:
   (i) Relieve absorptive capacity constraints
   (ii) Work around existing constraints

• Donors should be cautious not to ‘over-aid’ some Pacific countries when scaling-up