The long-term impact of aid

By Ron Duncan
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What causes economic growth? How long do periods of rapid economic growth last? How have the Pacific island countries (PICs) experienced growth? And what part does aid play in the cycle?

In one of his many insightful writings, [Lant Pritchett]() expressed his frustration at the "reams and reams of growth regressions" that have been undertaken over many years without yielding any clear idea about the factors underlying economic growth. Instead, Pritchett suggested that effort should be put into identifying periods of substantial growth in countries and, by developing an in-depth understanding of the country's situation, try to pinpoint the causes of the growth spurt (and its end).

Much effort has been given to the specification and estimation of growth regressions in the PICs, again without much clarity about the factors responsible for their economic growth, or lack of it. In my recent paper in *Asia & the Pacific Policy Studies*, I took up Pritchett's challenge in attempting to identify the reasons for growth (or lack of growth) in eight PICs, and develop narratives about the macroeconomic or microeconomic reasons for the growth episodes in each country.

In identifying growth spurts, a subjective benchmark has to be set to judge what could be considered a period of robust growth. The growth rates of the PICs do not compare with the recent rapid growth rates of the People's Republic of China or other fast-growing East Asian countries. Hence, real GDP growth rates averaging around three per cent or higher, sustained over a period of four years or longer, were taken as the periods to be studied.

The sample of countries included the three northern PICs that have Compact of Free Association agreements with the US: the Federated States of Micronesia (FSM), Republic of the Marshall Islands (RMI), and Palau. For FSM, one period of good growth was identified, from 1988 to 1993, as well as two periods of poor growth, 1994 to 1997 and 2001 to 2009. In the case of RMI, three periods of good growth were identified: two short periods of good growth, 1982 to 1984 and 1986 to 1988, were interrupted by a sharp recession in 1985. The other good growth period was 1992 to 1995. A negative growth period, 1996 to 1999, was also identified. Two growth episodes in Palau were selected: a three-year rapid growth period, 1994-96; and a five-year negative growth period, 2005 to 2009.

Two growth episodes in Kiribati were selected for study: a four-year negative growth period, 1984 to 1987; and a five-year positive growth period, 1996 to 2000. Two growth episodes were selected for Tuvalu: a four-year positive growth period, 1991 to 1994; and a seven-year negative growth period, 1999 to 2005.

All five countries receive relatively large amounts of aid. For the latter four, aid appears to have played the main role in the limited GDP growth spurts they experienced. FSM and Kiribati also receive relatively large revenues from fishing licence fees, while Tuvalu has fluctuating income support from the Tuvalu Trust Fund, its .tv domain name, and fishing fees. However, these revenue flows have not provided a basis for economic development.

Among the US Compact countries, Palau stands out for being able to foster growth through support for tourism, and it does not appear to have become as aid-dependent as the other two. In FSM, RMI, and Kiribati, aid dependency appears to have sapped incentives for entrepreneurship and development of the private sector.

Two growth episodes were selected for analysis for Samoa: a four-year negative growth period, 1990 1994; and an eight-year positive growth period, 2000 to 2007 (this sustained growth episode has only been matched by Vanuatu). Three growth episodes were selected for study in Vanuatu: a four-year positive growth period, 1981 to 1984; a five-year negative growth period, 1985 to 1989; and a seven-year positive growth period, 2003 to 2009. A six-year positive growth period, 1998 to 2003, was selected for analysis in Tonga. However, these were not years of robust growth, with two of the years yielding less than three per cent growth and no year as high as four per cent. In fact, Tonga has not had any outstandingly positive or negative growth periods.

Samoa and Vanuatu have been able to generate one sustained period of good growth, mostly through reform efforts and largely from tourism, as a result of liberalising international air services. Funding of construction activity has also helped. Tonga’s growth experience likely reflects the absence of positive policies and institutions on the one hand and the strong support from remittances on the other. Vanuatu has received very little assistance in the form of remittances as few Ni-Vanuatu have been able to migrate for work. Therefore, its ability to generate a sustained growth spurt in recent years, mainly through policy reforms supporting tourism, has been commendable.

The GDP growth differences between Palau, Samoa, and Vanuatu on the one hand and FSM, RMI, Kiribati, and Tuvalu on the other has largely been a function of the provision of a friendly business environment, in particular the development of tourism. The former PICs have secure property rights to land for tourism, as well as open markets for international airline services, mobile phones and Internet services. Thus they have globally integrated their tourism sector, which makes good economic sense given that PICs have a comparative advantage in tourism.

Overall, this suggests that unless it leads to changes in institutions and policies, aid does not have long-lasting, positive growth impacts. The limited experience of Samoa and Vanuatu does support the idea that reform can lead to growth spurts. On the other hand, as experience in FSM and RMI appears to show, substantial aid may raise GDP growth for short periods, but it may well have very adverse impacts over the long run.

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