Aid, Growth and Absorptive Capacity Constraints in the Pacific

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Overview

- Absorptive capacity constraints - definition
- Different types of constraints
- Aid and growth: the empirical evidence
- Policy response
Absorptive capacity constraints - definition

- Factors which limit the ability of recipient countries (and donors) to put aid flows to good use
- Implies that there are diminishing returns to aid after it reaches a certain level
- Increasingly important issue due to scaling up of aid
- Particularly important in Pacific countries (and fragile states)
Types of Absorptive Capacity Constraints

- Human capital constraints
  - Exist at a central administrative level
  - Exist at a sector level (lack of trained teachers, doctors, nurses etc)
- Weak policy/institutional environment
  - Can undermine aid effectiveness
- Dutch disease impacts of aid
  - Real exchange rate appreciation / export competitiveness
- Infrastructure
  - Particularly transport
- Poor donor practices
  - eg uncoordinated aid/lack of harmonisation
Aid and Growth: Empirical evidence

- Empirical literature has mostly examined the impact of aid on economic growth

Findings:
- Foreign aid, in general, works
- Impact varies - questions remain over where it works best
- There are diminishing returns to foreign aid
Relationship between aid and growth
Aid and Growth: Empirical evidence

- Diminishing returns appears to set in when aid accounts for 20 per cent of GDP
- Based on cross country data – so an average
- Absorptive capacity is lower in ‘highly’ fragile states
- Country specific estimates for the Pacific required
## Pacific Country Aid Receipts

<table>
<thead>
<tr>
<th>Country</th>
<th>ODA/GDP 2005 (%)</th>
<th>a*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiji</td>
<td>2.1</td>
<td>20</td>
</tr>
<tr>
<td>Kiribati</td>
<td>42.2</td>
<td>20</td>
</tr>
<tr>
<td>Marshall Islands</td>
<td>39.3</td>
<td>20</td>
</tr>
<tr>
<td>Micronesia</td>
<td>44.9</td>
<td>20</td>
</tr>
<tr>
<td>Palau</td>
<td>16.2</td>
<td>20</td>
</tr>
<tr>
<td>Papua New Guinea</td>
<td>5.4</td>
<td>20</td>
</tr>
<tr>
<td>Samoa</td>
<td>10.9</td>
<td>20</td>
</tr>
<tr>
<td>Solomon Islands</td>
<td>66.5</td>
<td>20</td>
</tr>
<tr>
<td>Tonga</td>
<td>14.6</td>
<td>20</td>
</tr>
<tr>
<td>Vanuatu</td>
<td>10.7</td>
<td>20</td>
</tr>
</tbody>
</table>
Policy response

• The existence of absorptive capacity constraints does NOT imply that donors should stop scaling up their aid programs?

Policy options:

1. Try to relieve absorptive capacity constraints
   (i) build existing capacity
   – Use aid to improve levels of human capital
   – Help strengthen institutions
   – Improve infrastructure
Policy Response

(ii) improve donor practices
   – Adhere to the principles of the Paris Declaration
   – Channel aid through other donors
   – Adopt a donor division of labour
Policy options

(2) Work around existing constraints

– Choose appropriate aid modalities (eg Technical assistance)
– Use channels other than the public sector to provide aid (eg NGOs, private sector)