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Aid or foreign direct investment: Which is good for Pacific islands?

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Last week, academics, government policy makers and businessmen from the region gathered in Suva and reviewed economic trends in Pacific island countries (PICs). They also explored future options for growth and development.

The event, known as Pacific Update, was sponsored by Asian Development Bank in conjunction with Australian National University and the University of the South Pacific (USP).

One of the topics of perennial interest is the role of foreign aid in growth and development in PICs. Known as overseas development assistance, aid is considered as unrequited or unreciprocated transfers of resources supplementing domestic savings for helping less developed countries (LDCs) to overcome their capital shortages. It was first pledged 35 years ago in a 1970 General Resolution of the United Nations that developed countries should transfer at least 0.7 percent of their gross domestic products each year to LDCs. The target of 0.7 percent has been re-affirmed from time to time in many international agreements over the years, including 2002 International Conference on Financing for Development and the World Summit on Sustainable Development held in Johannesburg.

Policy shift

The subject of aid effectiveness has already evoked greater attention in recent months due to a major policy shift by Australia.

It all began in 2014 with the abolition of the forty year old Australian International Aid Agency (AusAID), merging its functions with the Department of Foreign Affairs and Trade. The purpose was to support Australian foreign and trade policy. However, PICs were comforted when it was clarified that the geographic priority for aid will be the Indo-Pacific region, especially the South Pacific.

Australia has been the largest aid giver for many PICs. Its aid in terms of the GDPs of respective PICs ranges from Nauru: 65 percent, Papua New Guinea: 60 percent; Vanuatu: 40 percent; Fiji: 30 percent; Solomon Islands: 27 percent; Samoa: 20 percent; Tonga: 18 percent. Cuts in Australian aid were feared to have serious implications for all aid recipient countries, since most of the aid has been in recent years in growth enhancing areas, such as health and education projects, which have long gestation periods. Of course, there were other "soft areas" too, gains from which are highly nebulous.

Aid and FDI inflows

PICs continue to be among the top recipients of foreign aid in term of percentages of their gross domestic products, just as they rank high among the receivers of remittances. Vanuatu was the fourth highest aid recipient (13% of GDP) amongst PICs, next only to Solomon Islands (31%), Samoa and Tonga (17%), though higher than Fiji (2.7%), Vanuatu is among the least recipient of remittances. Vanuatu (3% of GDP) lags behind Samoa (23%), and Tonga (13%) and Fiji (4.7%).

On the other hand Vanuatu has been traditionally an attractive destination of foreign direct investment (FDI), which is influenced purely by profit motive. With no direct taxation of any kind and no exchange controls and with additional attraction of being a tax haven, FDI inflows were into agricultural projects such as cattle ranches and plantations in initial years and later in tourism industry.

Until mid 2000s, Vanuatu was the top recipient of FDI inflows (11 percent of GDP) followed by Fiji (4%). In recent times, Vanuatu was pushed to the third position with Solomon Islands becoming the first (17% of GDP) and Fiji, the second (11%) and Vanuatu, the third (5%).

Study on Vanuatu

A paper by this writer, coauthored with two USP academics (Dr Hong Chen and Markand Bhatt), was presented at the Pacific Update investigating the effectiveness of aid and FDI in Vanuatu.

The authors came to the conclusion that FDI, which facilitates transfer of technology and managerial skills through training, had a positive and significant effect on growth, whereas aid did not have any significant impact on output.

It is apparent that aid inflows were either spent on consumption or ineffectively utilized giving rise to fears expressed by Professor Helen Hughes and others in regard to effectiveness of aid to PICs.

The policy implications of the study are not new. They only confirm that while aid inflows are largely to government and other official agencies, effective use of aid needs improved policy framework and better governance measures.

The options are clear. Governments in PICs will do well to continue the present set of investor friendly incentives and attractive business environment.

How about the role of remittances in PICs? We will discuss the growing importance of remittances in growth vis- a-vis aid and FDI with a very recent study on Fiji, presented at another conference early this month held in Hawaii.