Does development aid have *in fine* positive or negative effects on growth in developing countries?
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Introduction

Successful economic recovery in Europe after the World War II thanks to the Marshall Plan has inspired policymakers in the 1960s, after the process of decolonization, to launch similar support programs to boost the economic growth in developing countries. Despite this effort, that has lasted over four decades, only few countries achieved to escape from the vicious cycle of poverty and there are still too many developing countries in the world today. Moreover, up to this day there is no clear theoretical model by which aid would influence growth and there have been a heavy discussion about the positive as well as negative effects of development aid on the economic growth.

We assume that development aid should have positive effects on growth when it is used properly. That was the primary purpose when these programs started. It should help developing countries to overcome the gap that is placed between them and developed countries and foster their economic growth and development as well as reduce poverty. However, intentions of industrialized countries have not been always righteous and they followed their own interests. There have also been predatory or corrupt governments in some developing countries who did not spend foreign aid on increasing national welfare but only their own. These cases might lead to zero positive impact or even negative impact of aid on growth.

In this paper we stem from the available sources on examining relation between aid and growth. We use the arguments of working papers developed by the World Bank, the IMF, the UN, the Centre for Global Development, articles published in economy and development journals and others. We examine the impact of aid on growth and some development outcomes in Burkina Faso using data and information available in the World Bank, the IMF and the DAC OECD web sites.

The first section describes theoretical background of development aid and its impact on economic growth. It follows the studies from the initial optimism in 1960s, through rising scepticism in 1990s, to recent debate about the need to improve the quality of aid and increase its effectiveness. A case study of Burkina Faso is presented in the second section. It compares the amount of received foreign assistance and the GDP growth rates, as well as tries to find other influential factors. In the third section the theory learnt and the results observed are compared and evaluated.
I. Theoretical Background

First theoretical study about the impact of development aid on the growth published in 1966 by Chenery and Strout introduced a “two-gap” model. The first gap represents the difference between the amount of investment necessary to attain a certain rate of growth and available domestic saving in developing countries. The second gap is formed by differing import requirements for a given level of production and foreign exchange earnings. Foreign aid can fill in these gaps and using the Harrod-Domar model bolster self-sufficient growth.

However, in the late 60s and 70s pessimism and scepticism started to spread out among the scholars seeing that the aid had not reach expected results. Consecutively it caused anxiety also among the policymakers who didn’t want their finances to be wasted. Finally, after steady rise of development aid over three decades, it dropped in 90s from US $60 billion in 1992 to US $48 billion in 1997. This situation is called also “aid fatigue” (Lensink, White, 2000).

In 1997 Burnside and Dollar published revolutionary findings in their paper Aid, Policies, and Growth, according to which the impact of aid depends on the quality of state institutions and policies. They claimed that aid has a positive impact on growth in developing countries with policies related to fiscal surplus, inflation and trade openness. On the other hand, corrupt institutions and weak policies limit the impact of financial assistance. Aid has no positive effect on growth in countries with poor policies. The consequence of this outcome was that the World Bank the USA reconsidered their development assistance flows and since then they have applied much higher selectivity in providing aid.

In the following period of time many papers emerged studying whether and when development aid works. Hansen and Tarp (2001) claimed that aid worked on average, but with diminishing returns. Guillamont and Chauvet (2001) stated that aid worked best in countries with difficult economic environments, characterized by volatile and declining terms of trade, low population, and natural disasters. Collier and Dehn (2001) declared that increasing aid cushions countries against negative export price shocks. According to Collier and Hoeffler (2004), aid worked particularly well in countries that were recovering from civil war and that had good policies. Chauvet and Guillamont (2003) found out that aid is more efficient when present policy is good or when the past policy was poor, as well as economic vulnerability to external shocks is a factor enhancing aid effectiveness. Dalgaard, Hansen and Tarp (2004) found out that aid raises growth outside the tropics but not in them. According to Clemens, Radelet and Bhavnani (2004), aid has positive effects when measured properly but
these are only of short-term. And Sachs (2005) in the UN Millennium Project assumed that aid has positive effects only when it is directed to real investment on the ground.

Furthermore, there were studies showing that aid may have even negative effects on developing countries. Rajan and Subramanian (2005) alert in the long run aid can be detrimental for economy. Firstly, development assistance is intended to be additional to the budget, but eventually the country becomes more lax on raising tax revenues. More aid is necessary just to keep the country on an even keel and leads to dependency on foreign aid. Secondly, financial flows from abroad lower accountability of government towards citizens and favours corruption. Finally, it may cause “Dutch Disease” effect. Rajan and Subramanian claim that via overvalued exchange rate aid inflows have systematic adverse effects on growth, wages, and employment in labour intensive and export sectors. Therefore it is important to measure absorptive capacity of a country and find out how much aid can be handled to begin with, how the aid should be delivered, and when. The IMF (2005) agrees that there is a need of coordination of fiscal policy with exchange rate and monetary policy. In addition, Moss, Pettersson and Van de Walle (2006) highlight potential negative effects of large and sustained volume of aid on the development of good public institutions in low income countries and undercutting incentives for revenue collection.

Other authors conclude that development assistance may not the stimulus that leads trapped countries out of poverty. Roodman (2007) states that probably factors as domestic savings, inequality, or governance are more decisive for development. Rajan and Subramanian (2008) in their later research show that there is little evidence of a robust positive correlation between aid and growth. Moreover, they question previous findings when they claim that there is little evidence that aid works better in better policy or institutional environment, as well as there is weak and mixed evidence that aid works better in some geographical settings. They add, similarly to Roodman, that effects of interventions, such as good policies, on growth are indeed discernible in the data and are robust. McGillivray, Feeny, Hermes and Lensink (2005) admit supportive but not decisive role of aid toward development and claim that growth would be lower and poverty would be higher in the absence of aid. However, Fielding, McGillivray and Torres (2006) brought a more optimistic view of aid effectiveness when demonstrating straightforwardly positive effect of aid on development outcomes. They explain that aid might promote investment in human capital and have positive impact on human development, whereas its impact on labour productivity and investment in physical capital may bring mixed results. Therefore it is difficult to observe positive long-term effect of aid on growth.
In searching for reasons for low aid efficiency academics concur that it is not amount but **quality of aid** that matters. Almost all defects are named in *UN Millennium Project* by Sachs (2005). It states that aid is highly unpredictable, tied to contractors from donor countries, targeted at technical assistance and emergency aid rather than investments, long-term capacity, and institutional support. It is often driven by separate donor objectives rather than coordinated to support a national plan, as well as overly directed to poorly governed countries for geopolitical reasons and is almost never evaluated or documented systematically for results. Fragmentation of aid among many recipient countries and among numerous sectors also decreases its efficiency and increases administrative costs. Sundberg and Gelb (2006) point out an important fact, that 38% of total official development assistance (ODA) and only one quarter of bilateral aid is directed to project and program support in developing countries. Remaining part is divided among administrative costs (8%), emergency and food assistance (13%), technical cooperation (21%) and debt relief (20%) of which none contributes to growth or development. Moreover, these shares have been increasing and are responsible for the fact that even if the amount of ODA rises, the net amount of aid remains at the same level.

Conditional aid has proved to be ineffective, too (White and Morrissey, 1997). It doesn’t promote reform in all cases and often even inhibits these efforts when recipients are willing but unable to implement all conditions. Furthermore, it undermines its own credibility by encouraging donors to condone slippage.

A huge problem is still aid volatility and unpredictability (Bulíř and Hamman, 2008) because it makes impossible for developing countries to plan their expenditures. However, it affects not only government spending but also its composition and effectiveness. According to calculations of Celasun and Walliser (2008), 1% GDP aid shortfall brings about 0.1- 0.2% GDP fall of investment spending and no fall in government consumption. On the other hand, 1% GDP aid windfall raises government consumption of 0.6% GDP but no investment spending rise.

Bourgignon and Sundberg (2007) try to examine aid effectiveness and track the route of aid towards its outcomes through three relationships: donors- policymakers, policymakers-policies and policies-outcomes. They suggest reshaping the aid model to country ownership of the development strategy and aid allocation based primarily on monitorable results in order to increase aid effectiveness.
II. Case study: Development Aid in Burkina Faso

Burkina Faso is a low-income, landlocked, Sub-Saharan country with limited natural resources and 14 million inhabitants. The country’s economy is highly dependent on cotton exports and is vulnerable to exogenous shocks. From 1998 to 2006, Burkina Faso maintained an average growth rate of over five percent per annum. Between 2008 and 2009, annual growth rate contracted from +5.2 percent in 2008 to +3.2 percent in 2009, as a result of a series of exogenous shocks: global economic downturn, lower demand for cotton and heavy floods in September.

Burkina’s poverty rate is 43 percent and the country ranks 177th out of 182 countries in the 2009, Human Development Index of the United Nation’s Development Programme (UNDP). Human development indicators show positive trends but the numbers remain still alarming (See Table 1).

The economy relies predominantly on the performance of the cotton sector – which represented 32 percent of exports in 2008. This makes the economy particularly vulnerable to fluctuating cotton prices and to the impact of climate changes.

Burkina Faso has enjoyed political stability since 1987, with the “rectification” of the revolution, which marked a shift toward more market-oriented economic policies and re-engagement with the international community. Since 1991, presidential, legislative and municipal elections are regularly held. In November 2005, President Blaise Compaoré was reelected. The next presidential elections are scheduled for November 2010. There is a high demographic growth rate in Burkina Faso (3.4 % in 2008, World Bank data) which hinders initiatives to reduce poverty and foster human development. It also increases food insecurity, accelerates environmental degradation and might cause problems in the job market in the long run.

The ODA flows in Burkina Faso are coincident with the ODA trends in general. Since 1960 they were rising for three decades, in 1990s they dropped and since 2000 there is a steady increase in the development assistance to Burkina Faso (See Graph 1).

In 2000 developed the Burkina Faso Government a Poverty Reduction Strategy Paper (PRSP) which describes country’s macroeconomic, structural and social policies and programs to promote growth and reduce poverty, as well as associated external financing needs. It set objectives to accelerate growth based on equity, ensure that the poor have access to basic social services, expand opportunities for employment and income-generating activities and promote good governance. The action plan focuses on three priority sectors:
education, health, and rural development, where public interventions have the highest payoff in terms of economic growth, employment opportunities, and the quality of life. It provide also the basis for World Bank and IMF assistance as well as debt relief under the HIPC (Heavily Indebted Poor Countries) initiative.

Burkina Faso has systematically received aid from multilateral agencies and they are the most important donors. After broadly satisfactory results of three medium-term Poverty Reduction and Growth Facility (PRGF)- supported programs in 1993-2003 and faithfully followed policy agenda adopted in 2000, the IMF approved in 2003 another three-year economic program supported by PRGF providing SDR 24.08 mil. (approximately US$ 35.5 mil.). In 2006 ensured the IMF a 100% debt relief to Burkina Faso in accordance to HIPC initiative. In 2007 a new three-year PRGF-supported program of SDR 15.05 mil. (US$ 22.4 mil.) was approved by the IMF. It should have helped Burkina Faso move towards the Millennium Development Goals (MDG) of reducing the poverty rate to below 35 percent by 2015 while achieving per-capita growth rates of at least 4 percent. It was focused on raising domestic revenues, strengthening public financial management to allow for better domestic absorption of aid and more effective poverty-reducing spending, increasing private sector participation to accelerate growth and diversify economic activity; and maintaining debt and fiscal sustainability. According to the Statement by IMF Staff Mission to Burkina Faso from April 2010, „Performance under the ECF-supported program was in line with expectations. Quantitative targets were met; and structural reform measures were implemented as planned, except for two measures that will be completed in coming weeks.‟ It also states that „it is expected that the review of performance under the current ECF and the proposed policy framework for a new ECF-supported program will be considered by the IMF’s Executive Board in June 2010‟.

The World Bank is an important donor, too. Its projects contributed, for example, to community based development of 302 rural communes, increased the access to drinkable water from 300 000 to 1 million citizens of Ouagadougou, raise the teledensity rate from 1.5 telephone lines per 100 inhabitants in 2003 to 27.9 in 2009\(^1\), helped to improved business environment and improved management and transparency in the mining sector. There are 16 projects in the current Bank portfolio now with amount of US$ 658 mil. commitments. Furthermore, a Country Assistance Strategy (CAS) has been approved for 2010-2012 in amount of US$ 161 mil. which aims to reduce economic vulnerability and promote growth.

\(^1\) World Bank data
through economic transformation and increase growth sharing through improved service strategy.

III. Facts Summary

When we search for an impact of development aid on growth and we look at the amount of received aid (Graph 1) and the GDP growth rate (Graph 2) in Burkina Faso, we cannot see a straightforward correlation. Since 1960s the amount of aid has been rising steadily, except for a decline in 1990s, whereas the growth has been highly volatile. However, we may observe that the growth volatility has been lower since 2000. In this period of time the amount of aid has increased fivefold. Also a discussion and many initiatives took place in the world in the recent decade in order to increase aid effectiveness. Nevertheless, it is difficult to conclude, whether this slightly positive trend in the GDP growth rate was caused by the received development aid or not. There are many other factors influencing economic growth in Burkina Faso which cannot be excluded when considering this evolution. External shocks as well as climate changes proved to have immense impact on the Burkinabe economy. The IMF efforts to improve macroeconomic stability in the country and implemented policies might also participate on this evolution.

According to the World Bank’s description of political situation in the country and IMF statements about implemented economic reforms we may state that Burkina Faso is a country with a good policy, which according to Burnside and Dollar (1999) should promote positive effects of aid on growth. However, we cannot validate nor disprove this theory.

Considering the “Dutch Disease” effect, the Burkinabe export is formed mainly by cotton and gold production. These are the productions of primary sector, not the manufacturing. Therefore we cannot observe whether aid inflows have negative impact on exportable sectors.

Celasun and Walliser (2008) in their research claim that in 1993-2005 average budget aid in Burkina Faso was 3% of GDP. However, one third of this aid arrived unexpectedly. This unpredictability might remarkably influence the aid effectiveness and the purpose for which it is used.

Nevertheless, according Fielding (2006), even if long-term positive effects of aid on growth cannot be observed, development assistance has positive impact on human development. He shows in his study that foreign aid in Burkina Faso increases material assets,
improves sanitation, decreases fertility and child mortality and has positive impact on education.
Conclusion

There is no theoretic model that would definitively show the mechanism how development aid affects growth, so far. However, several studies have examined the relationship between them trying to assume the effects.

Development aid might have positive impact on growth as it is a source of investment. In 1999 a study by Burnside and Dollar claimed, that foreign assistance has positive effects on economic growth only in countries with “good policies and institutions”. Consecutively, following this projection, higher selectivity has been applied by multilateral agencies and donor countries providing development assistance. Other studies claim that foreign aid has better positive effects in countries that are highly vulnerable to external shocks, in difficult economic environment or after a civil war. Some academics assume that aid can have positive impact but not in the tropics.

Many scholars warn against negative impacts of aid. It might weaken state institutions or favour corruption in recipient countries. In the long run it might lead to overvaluation of real exchange rate and decrease competitiveness of exportable sectors. This might negatively influence not only the growth but the whole country’s economy.

However, the quality of aid cannot be neglected. Donor countries have often followed their economic, political or strategic aims and were not really interested in the development of the recipient country. Moreover, developing countries receive less than a half of the proclaimed official development assistance. Other items such as administrative costs, technical cooperation, food and emergency aid and debt relief represent remarkable part of ODA but they do not contribute to development. There is a need to better coordinate and align development programs to achieve better outcomes and cooperation with recipient country’s government is inevitable.

It is impossible to define whether development aid has in fine positive or negative effects on growth in developing countries because this depends on many other factors which cannot be excluded from the observation. Furthermore, every country has different characteristics influencing the impact of aid which do not permit to make broad generalizations.
## Annex

### Table 1.

<table>
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<tbody>
<tr>
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<td>11,68</td>
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<td>GNI, Atlas method (current US$) (billions)</td>
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<td>Life expectancy at birth, total (years)</td>
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<td>Fertility rate, total (births per woman)</td>
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<td>Mortality rate, under-5 (per 1,000)</td>
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<td>Primary completion rate, total (% of relevant age group)</td>
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<td>Improved water source (% of population with access)</td>
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<td>Improved sanitation facilities, urban (% of urban population with access)</td>
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<td>GDP (current US$) (billions)</td>
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<td>Industry, value added (% of GDP)</td>
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<td>Services, etc., value added (% of GDP)</td>
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<td>Exports of goods and services (% of GDP)</td>
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<td>Imports of goods and services (% of GDP)</td>
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<td>Gross capital formation (% of GDP)</td>
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<td>Revenue, excluding grants (% of GDP)</td>
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<td>Internet users (per 100 people)</td>
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<td>External debt stocks, total (DOD, current US$) (millions)</td>
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<td>1,456</td>
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<td>Workers’ remittances and compensation of employees, received (current US$) (millions)</td>
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<td>50</td>
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<td>Foreign direct investment, net inflows (BoP, current US$) (millions)</td>
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<td>344</td>
<td>137</td>
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<td>Net official development assistance and official aid received (current US$) (millions)</td>
<td>338</td>
<td>694</td>
<td>951</td>
<td>998</td>
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**Source:** World Bank, World Development Indicators database, April 2010

**Graph 1:** Burkina Faso ODA recieved (US$ mil.)

Source: DAC OECD data
**Graph 2**: Burkina Faso GDP Growth (annual %)

![Graph 2: Burkina Faso GDP Growth (annual %)](image)

Source: World Bank data

**Graph 3**: Burkina Faso Net ODA received (% of GNI)

![Graph 3: Burkina Faso Net ODA received (% of GNI)](image)

Source: World Bank data

**Graph 4**: Composition of Burkina Faso 2008 debt (US$ mill.)

![Graph 4: Composition of Burkina Faso 2008 debt (US$ mill.)](image)

Source: World Bank, Burkina Faso at a glance, 12/9/09
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