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## **Development Effectiveness of Foreign Assistance**

International aid is given in order to generate economic growth and development in developing countries. The theoretical and empirical research on aid-growth effects are extensive and multidimensional. Studies of aid effectiveness are very important because they address basic question: Is foreign aid the basic remedy for economic growth and poverty reduction in poor aid-recipient countries? However, the results of aid effectiveness are ambiguous. They depend on many different factors. Among them, the main are differences in models and estimation techniques and differences in countries and periods considered in the studies.

The aim of this article is to investigate the relationship between foreign aid and economic growth.

### EVOLUTION OF FOREIGN ASSISTANCE

Generally foreign assistance is defined as a transfer of capital from governments or public institutions of developed countries to governments of developing ones. It takes a form of official bilateral and multilateral flows or private flows. Resources provided by the government of donor to the government of recipient countries are called official bilateral flows. Capital flows from multilateral organizations such as the World Bank (WB) or the International Monetary Fund (IMF) are official multilateral flows. Official flows can be divided into grants and loans.

Foreign aid inflows have grown significantly after the Second World War. The first important bilateral assistance was the European Recovery Program (1948–1952) known as the Marshall Plan. This aid from the United States to war-devastated countries of West Europe very soon started to be viewed as an

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example of development aid effectiveness and thus become a justification of foreign assistance for decades. It happened despite the fact that the main aim of the Plan was a reconstruction not a development of destroyed European countries. Moreover, some countries like France, Germany or Italy had begun their recoveries before the plan was implemented and others (Austria, Greece) began to revive after the inflow of aid had been stopped.

The form of foreign aid evolved in the post-war period. Besides, the role of different institutions also has changed during the past few decades. In the 1950s official bilateral flows dominated. Mainly two countries i.e. the United States and the Soviet Union were involved in the international assistance. However, until the mid-1950s only the US was the important donor. According to Hjertholm and White [2000, p. 11] the United States accounted for 2/3 of total aid in the mentioned decade.

In 1949 Truman announced the Point Four Programme. Thus he initiated an American technical assistance programme in the fields of agriculture, public health and education for poor countries in Africa, Asia and Central and South America. Additionally the food aid programme known as Food for Peace began in 1954. Throughout the fifties a large aid was granted to South Korea, Taiwan and South Vietnam.

The Soviet Union started to support intensively less developed countries in the middle of the fifties. The aid was mainly concentrated in the Middle East and South Asia countries. In 1956 at the XX Congress of the Communist Party of the Soviet Union Khrushchev announced the expanded Soviet aid programme. Newly independent developing countries could be supported with generous grants in order to develop their economies along socialist lines.

Throughout the 1950s the aid mostly took the form of a food aid and different kinds of technical projects. However, it should be noted that the aid was treated as a tool in the ideological war between the United States and the Soviet Union. United States provided assistance to underdeveloped countries in order to contain the spread of communism. Not only in the fifties but during the whole period of the Cold War (1947–1991) the international assistance was an important part of foreign and commercial policy for both countries.

In the 1960s and the 1970s bilateral programmes were continued and developed. In 1961 Kennedy announced that the sixties would be the decade of development. He initiated the Alliance for Progress that was a 10-year programme of cooperation with Latin America countries. In the same year the United States Agency for International Development was created. This institution was responsible for administration of the bilateral economic assistance. First of all the state led initiatives and activities in recipient countries were supported.

The Soviet aid was also allocated to large industrial projects in the public sector of developing countries (a large steel plant in India and Turkey, the Aswan Dam in Egypt, metallurgical projects in Algeria, Libya, Nigeria, irrigation

projects in Algeria). Besides, the Soviet Union offered loans to exploit natural resources (mainly oil and gas) and establish independent national industries in recipient countries. Such loans were given to Afghanistan (1963), Algeria (1966), Iran (1966), Guinea (1969), Syria (1969) and Iraq (1969-1971) [Guan-Fu, 1983, p. 87]. The Soviet Union not only delivered machinery and equipment for assistance projects or transport materials but also dispatched technicians to developing countries and provided training for local personnel.

In the sixties other economically advanced countries started to participate in world aid programmes. In 1960 the world's main donors established the Development Assistance Group<sup>2</sup> (DAG) to coordinate their aid policies. A year later the DAG became the Development Assistance Committee (DAC). In 1969 the DAC introduced the concept of Official Development Assistance (ODA)<sup>3</sup> separating it from Other Official Flows. After the publication of the Pearson Commission Report entitled "Partners in Development" the DAC members agreed to transfer 0.7% of their national income to developing countries<sup>4</sup>.

In the early seventies the assistance from multilateral institutions expanded. Multilateral aid gained significance with the development of the Bretton Woods Institutions. In 1960 the World Bank set up the International Development Association (IDA) in order to provide assistance in the form of loans and grants to the poorest countries in the world. Besides, other development institutions were established. For example the Inter-American Development Bank was founded in 1959, the African Development Bank in 1964 and the Asian Development Bank in 1966. These regional development banks started to offer financial and technical aid for development in low-income and middle-income countries.

In the 1960s donors were engaged in technical assistance with budget support to recipient countries. A decade later the foreign aid was shifted to social sectors like education and health and also poverty reduction. In the 1980s the ideology of foreign aid changed again. The international debt crisis and the emergence of the balance-of-payments problems in many countries changed the aid policy of the major world's donors. First of all they decided to support the market approach to development, market reforms and structural adjustment ef-

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<sup>2</sup> The original DAG members were Belgium, Canada, France, Germany, Italy, Japan, the Netherlands and Portugal. In 1961 the United Kingdom, the United States and the Commission of the European Economic Community joined the DAG/DAC.

<sup>3</sup> ODA consists of flows of concessional financing to developing countries and multilateral institutions provided by official agencies. The flows must contain a grant element of at least 25% (using a fixed 10% rate of discount). The main objective of ODA is the promotion of the economic development and welfare of developing countries [www.oecd.org/dac].

<sup>4</sup> Sweden and the Netherlands were the first countries that reached the target in 1975. Besides, Norway (1976), Denmark (1978) and Luxemburg (2000) achieved it. The mentioned countries have met the target since. No other DAC country (except Finland in 1991) has met the target of giving 0.7% since it was established [www.oecd.org/dac].

forts in developing countries. The foreign aid took a form of the budget support conditioned on policy reforms [White, Feeny, 2003, p. 115]. The international financial institutions, the IMF and the World Bank developed stabilization and structural adjustment programmes for developing countries.

The fall of the Berlin Wall in 1989 ended the Cold War and shifted the foreign assistance to the centrally planned economies of the Central and Eastern Europe and the Soviet Union. Countries of the former Soviet bloc were supported in their transition to market economies. Donors concentrated first of all on governance issues. In the second half of the eighties the aid was also directed to the countries that suffered because of the Asian financial crisis. Of course throughout the whole decade poor countries in Sub-Saharan Africa and South Asia were aid recipients. Poverty reduction again became one of the main objectives of donors as a consequence of the 1990 World Development Report on poverty.

Apart from the international efforts in poverty reduction the process of foreign debt relief for the poorest countries was initiated. In 1996 the World Bank and the IMF launched a debt initiative for the heavily indebted poor countries.

The 21<sup>st</sup> century began with the Millennium Summit of the United Nations where international development goals known as the eight Millennium Development Goals were established. The goals assume halving extreme poverty, providing universal primary education, reducing child mortality rates, improving maternal health and halting the spread of HIV/AIDS by the target date of 2015.

In 2005 a new trend in the foreign assistance was observed. According to the Hong Kong WTO Ministerial Declaration the expansion of aid might help developing countries to build their supply-side capacity and trade-related infrastructure and more broadly expand their trade [WT/MIN(05)/DEC, p. 11]. The foreign aid is necessary for the development of trade.

It is worth noting that, at the beginning of the 21<sup>st</sup> century the next justification of the foreign assistance appeared. Rich countries have to transfer resources to poor countries because they need allies in the Global War on Terrorism.

The foreign assistance in the last decades was determined by the changes in geopolitics and the changes in ways of thinking about development.

## THEORETICAL JUSTIFICATION OF FOREIGN ASSISTANCE

In the 1950s the idea of foreign aid was supported by development theories. In that time the main development objective was GDP growth. Other economic and social objectives were treated as complementary to it. Theories emphasised the role of investment in economic growth. For example Rosenstein-Rodan [1943, 1961] claimed that only a large amount of investment (big-push) could initiate development in developing countries. This idea was supported by

Nurkse's balanced growth theory. Nurkse [1953] argued that the lack of capital was the main constraint to set an economy on the path of development. Rostow [1956] stressed that take-off into sustained growth required a minimum threshold of the investment in underdeveloped countries. Similar conclusion followed from the critical minimum effort thesis [Leibenstein, 1957]. Besides, the idea that poor countries remained poor because of a "vicious circle of poverty" was developed by different economists [Nelson, 1956; Myrdal, 1957; Hirschman, 1958].

In the sixties two-gap models were developed. They directly showed the role of foreign aid in economic growth. The most influential two-gap model was designed by Chenery and Strout [1966]. In this model economic growth in the short-run is driven by capital accumulation. The level of investment consistent with a target growth rate is proportional to the growth rate and the incremental capital-output ratio. However, there are two main constraints that limit economic growth i.e. the investment-savings gap or the foreign exchange gap (the balance-of-payments gap or the trade gap). Poor countries have low levels of domestic savings and/or insufficient foreign exchange reserves (to import capital goods for investment) and hence low investment and low economic growth. Foreign aid can fulfil the gap between investment requirements and available domestic resources. However, the one-to-one relation between foreign aid and investment is required.

The Chenery-Strout two-gap model became the theoretical basis for the World Bank's aid programmes. In the 1970s and 1980s the WB used the Revised Minimum Standard Model (RMSM) to estimate the levels of investment and foreign financing that are needed to achieve a target for economic growth in developing countries. Nowadays its sequential extensions (the RMSM-X and the RMSM-XX) are used to forecast economic growth and development [Nowak, 2013, p. 37].

In the seventies the GDP growth stopped to be the dominant development objective. Development objectives changed because the most important problems were: unemployment, an increase in income inequality, a rise in number of people living below some minimum income level and the balance-of-payments disequilibrium [Thorbecke, 2006, p. 10–11].

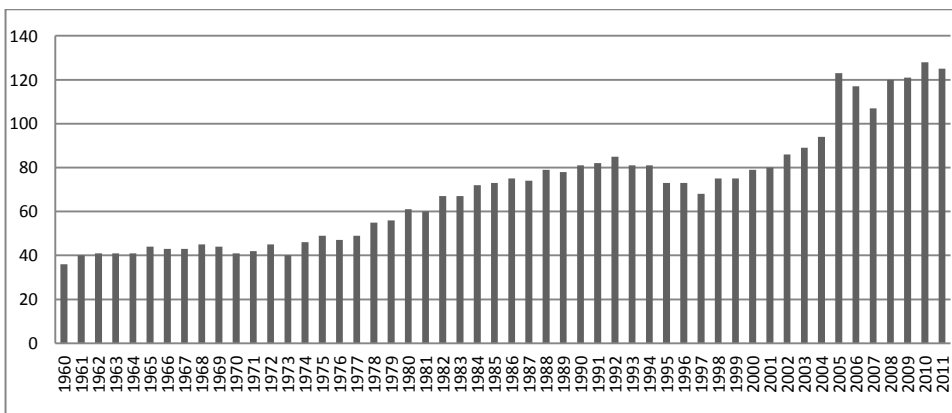
In the 1980s the main development objectives changed again. Macroeconomic stability was viewed as a necessary condition for economic growth and development. Developing countries should first achieve and maintain internal and external (balance-of-payments) stability. In order to do this they could participate in different stabilization programmes run by the IMF. However, supported countries had to realize tight monetary and fiscal policies because the IMF's stabilization programmes were based on the Polak model on monetary programming. According to this model a control over net domestic credit expansion is the key to stabilize the level of foreign exchange reserves and therefore the balance of payments. The model shows how to calculate the rate of domestic credit creation consistent with a target improvement in the balance of payments [Nowak, 2012, p. 35].

In the next decade the implementation of structural adjustment policies was still recommended for developing countries. Besides, institutional changes and better governance were perceived as key determinants of economic development. In the second half of the 1990s, after shock therapies in some transition countries and the Asian financial crisis, capital and trade liberalization, deregulation of banking and financial system or the minimization of government intervention were not so strongly recommended in order to achieve economic growth and development. Besides, the first generation of endogenous growth models initiated a broad discussion on the role of government in an economy. In 1988 Lucas designed the human capital model. According to the model investment in human capital is one of the major determinant of economic growth. On the other hand P. Romer [1990] emphasised the role of technical progress in economic growth. These models provided rationale for the state investment in human capital, education, health and research and development sector.

In the 2000s the main development objectives were human development, poverty and inequality reduction.

#### RELATIONSHIP BETWEEN FOREIGN AID AND ECONOMIC GROWTH — A SURVEY OF EMPIRICAL STUDIES

Since the beginning of sixties, the member countries of DAC have spent more than 3 trillion USD on official development assistance. In the last a few decades a huge increase in foreign aid to developing countries was observed. The trend of ODA is presented in figure 1.



**Figure 1. Trend in net ODA to developing countries, 1960-2011  
(USD billion, 2010 prices)**

Source: <http://dx.doi.org/10.1787/888932700979>.

In 1960, ODA measured in constant 2010 prices was equal about USD 36 billion. Since the early seventies an upward trend in the value of foreign aid has been observed. The value USD 85 billion was reached in 1992. From that year the volume of ODA had begun to decline. The decrease in the assistance continued until 1997 and was mainly a consequence of the strong faith in the market approach to development. Aid dropped by 20 per cent from 1992 to 1997. Since then, after some fluctuations, the aid has increased to USD 125 billion in 2011. During the period 1960–2011 the volume of ODA increased by over 240 per cent. Total ODA amounts have been more than USD 100 billion per year from 2005.

Although foreign aid flows were mainly dictated by political and strategic consideration [Alesina, Dollar, 2000, p. 33], economists have tried to analyse their development effectiveness. The first empirical studies on this problem were undertaken in the 1960s. However, early research investigated the impact of aid on savings. Most of them conclude that only a fraction of the foreign assistance has augmented savings while a large share was used to increase public consumption [Papanek, 1972, p. 935].

A positive impact of foreign aid flows on economic growth in recipient countries was confirmed by Papanek [1973] and Dowling and Hiemenz [1982]. Papanek applies cross-country regression analysis to thirty four developing countries for the 1950s and fifty one for the 1960s. He argues that the aid has greater effect on GDP growth than domestic savings or foreign investment. Dowling and Hiemenz find strong evidence that foreign aid has been positively associated with higher growth rates in fourteen Asian countries. They use data for the seventies. However, the impact of aid on income growth is higher in the middle income countries (Thailand, Philippines, Malaysia, Republic of Korea, China, Hong Kong, Singapore, Indonesia) than in the low income countries (Bangladesh, Nepal, Burma, India, Sri Lanka, Pakistan).

The positive and statistically significant relationship between aid and growth in the sample of the poorest countries (UK-aided countries in Africa) for data covering the period 1970 to 1977 was found by Mosley [1980]. Moreover, the positive impact of aid on growth in the case of 28 Sub-Saharan countries in the years 1968-1982 was confirmed by Levy [1988].

In the 1990s the rise of econometric studies on the efficiency of foreign aid was observed. However, economists changed their approach to the aid-growth issue. They mainly examined whether aid effectiveness was conditional.

For example Durberry et al. [1998] used growth regressions with policy variables for 68 developing countries over the period 1970-1993. According to their research greater foreign aid inflows have a positive effect on economic growth in developing countries, conditional on a stable macroeconomic policy in those countries. Similar conclusion follows from the paper written by Burnside and Dollar [2000]. Authors conclude that foreign aid has a positive impact on economic growth in developing countries with good fiscal, monetary and trade poli-

cies. The conclusion that the aid has little effect in countries with poor policies is also supported by Hansen and Tarp [2000, 2001]. Generally, the foreign aid is beneficial to countries with low inflation, small budget deficit, openness to trade, strong rule of law and competent bureaucracy.

Guillaumont and Chauvet [2001, p. 68] find that aid effectiveness depends on environmental factors such as the terms of trade, the extent of export instability and climatic shocks. However, authors claim that the positive effects of aid are stronger in the more vulnerable countries. The worse the environment, the greater the need for aid and the higher its productivity.

Other economists argue that the aid effectiveness depends on geographic location too. According to Dalgaard et al. [2004, p. F191] the aid is effective in accelerating economic growth but the magnitude effect depends on climate-related circumstances.

The development effectiveness of foreign assistance depends also on the size of the aid flows. The foreign aid has negative effect on growth after certain threshold level. Low amounts of aid or too high comparing to GDP do not generate faster grow. However, in the literature the optimal level of aid varies between 5% [McGillivray et al., 2006, p. 1040] to 40-45% of GDP [Durbary et al., 1998, p.17].

Effectiveness of the foreign aid is sensitive to the type of aid too. According to Ouattara and Strobl [2008, p. 360] the project aid financing is positively associated with growth, the financial programme aid has a negative effect on growth, the impacts of technical assistance and food aid are insignificant or weakly positive.

Doucouliagos and Paldam [2008, p.18] claim that there are over one hundred papers supporting the view that the foreign assistance generates development in recipient countries but their results mostly are not statistically significant.

On the other hand, there are a great number of econometric research that show negative correlation between the foreign aid and economic growth. The review of such studies is presented for example in Lessmann and Markwardt [2012].

## CONCLUDING REMARKS

Since the 1960s, developed countries have spent billions of USD to promote development in developing countries. Hence, the relationship between the foreign assistance and economic growth has been investigated by many economists.

Principally two main groups of the empirical literature on the effectiveness of development aid can be distinguished. The first studies argue that the positive relationship between the foreign assistance and economic growth exists. The aid is necessary for economic development and poverty reduction in less developed countries. It supplements domestic savings and/or allows the access to foreign markets.

Very often the relationship between the foreign aid and economic growth is conditional and depends on many different factors (specific conditions in a re-



recipient country, macroeconomic policy, geographical location, levels of aid allocation, aid modalities).

On the other hand, a number of research concluded that the foreign assistance is negatively correlated with economic growth. Moreover, the aid is wasted, increases public consumption, removes private savings, rises corruption and aid-dependency of recipient countries.

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### Summary

Since the beginning of the 1960s, developed countries have spent over USD 3 trillion on official development assistance to promote economic growth and development in developing countries. Over the last few decades not only major donors but also aid objectives have been changing. The aid objectives reflected changes in geopolitics, the development objectives and views on the

development process. Foreign aid very often was treated as an important tool of donors' foreign and commercial policies.

Theoretical studies developed in the sixties support the positive relationship between the foreign aid and economic growth. Two-gap model was used as the basis for calculation of aid requirements.

The empirical research on the effectiveness of development aid are extensive and multidimensional. However, their results and conclusions are ambiguous. Principally there are two main strands of the literature on the relationship between foreign aid and economic growth. One group of studies claims that there is the positive aid-growth correlation, the second argues that this correlation is negative.

Positive correlation between the foreign aid and economic growth can be either unconditional or conditional. In the second case the aid effectiveness depends on many different factors. The most important are specific conditions in the recipient countries, macroeconomic policy, geographical location, levels of aid allocation and aid modalities.

*Keywords:* foreign aid, effectiveness, economic growth, economic development, ODA

## **Efektywność wykorzystania pomocy zagranicznej na cele rozwojowe**

### *Streszczenie*

Od początku lat 60. ubiegłego wieku kraje wysoko rozwinięte przeznaczyły ponad 3 biliony dolarów amerykańskich na oficjalną pomoc rozwojową dla krajów słabo rozwiniętych. W ciągu ostatnich kilku dekad nie tylko zmieniali się główni donatorzy, ale także cele, na które przeznaczana była pomoc. Cele, którymi kierowali się darczyńcy, zależały od rozwoju sytuacji geopolitycznej, obowiązującej w danym czasie doktryny rozwoju gospodarczego oraz poglądów dotyczących właściwych celów rozwojowych. Pomoc zagraniczna często była traktowana przez donatorów jako ważne narzędzie polityki zagranicznej i handlowej.

Rozwinięte w latach 60. XX w. modele ukazywały pozytywny związek między pomocą zagraniczną a wzrostem gospodarczym. Model dwóch-luk wykorzystywano w celu ustalenia poziomu pomocy niezbędnego dla danego kraju.

Badania empiryczne dotyczące efektywności wykorzystania pomocy zagranicznej na cele rozwojowe są obszerne i wielowymiarowe. Jednak uzyskane wyniki nie są jednoznaczne. Zasadniczo, w literaturze przedmiotu można znaleźć dwie wykluczające się odpowiedzi na pytanie dotyczące wpływu pomocy zagranicznej na wzrost gospodarczy. Według jednej grupy badaczy istnieje pozytywna korelacja między pomocą zagraniczną a wzrostem gospodarczym, a według drugiej – negatywna.

Korelacja pozytywna może być bezwarunkowa lub warunkowa. W drugim przypadku, efektywność wykorzystania pomocy zagranicznej na cele rozwojowe zależy od wielu różnych czynników. Wśród nich za najważniejsze uważa się: warunki społeczno-gospodarcze panujące w kraju otrzymującym pomoc, prowadzoną przez niego politykę makroekonomiczną, jego położenie geograficzne, a także poziom oraz formę pomocy zagranicznej.

*Słowa kluczowe:* pomoc zagraniczna, efektywność, wzrost gospodarczy, rozwój gospodarczy, ODA

JEL: F35, O11, O19, O40