

# THE LINK BETWEEN OFFICIAL DEVELOPMENT ASSISTANCE AND INTERNATIONAL TRADE FLOWS – INSIGHTS FROM ECONOMIC THEORY

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## Abstract

As noted in many studies of development aid there are many reasons why one might expect to observe a correlation between aid and trade flows from a donor to a particular recipient. The paper firstly presents Bulgarian participation in development cooperation to disclose the motivation for studying the relation between aid and trade. The main section summarises some insights from economic theory literature on the rationale and the potential economic gains of development assistance donors as well as the findings of a number of studies analysing the existence, direction and strength of the linkage between the dynamics and volume of development aid and international trade flows. The last section outlines the author's intentions for a future own study on this correlation.

**Keywords:** ODA, Development assistance, TOF, international trade

**JEL classification:** F14, F35

## Introduction

International trade and foreign aid are the two main instruments for generating and reallocating wealth in the world economy and represent important ways through which industrialised countries can contribute to the development of poorer nations.

The policy for cooperation with developing countries is new to Bulgaria as in the course of the transition over the past two decades assistance to these countries could not be a foreign policy priority for obvious reasons. On the other hand, relations between Bulgaria and many of these countries in the decades before left a lasting mark in many of them, contributing to their economic development. In recent years, serious efforts have been made in Bulgaria to restore good practices in this respect, to rebuild the Bulgarian presence in developing countries on the basis of the existing former experience and of the new aims and priorities of Bulgarian foreign policy. After the end of the transition to a market economy and the accession to the European Union, Bulgaria has the task of restoring its position as a donor of international aid under the new conditions. The implementation of Bulgaria's transition from the status of a recipient of international aid into a donor makes it necessary a special attention to be paid to the many issues in this regard because of the specific commitments arising from the country's new status.

The paper firstly presents Bulgarian participation in development cooperation to disclose the motivation for studying the relation between aid and trade aimed at drawing recommendations on the strategic priorities which Bulgaria has to set in its participation in the International Development Cooperation. The main section summarises some insights from economic theory literature on the rationale and the potential economic gains of development assistance donors as well as the findings of a number of studies analysing the existence, direction and strength of the linkage between the dynamics and volume of official development aid (ODA) and international trade flows. The last section outlines some directions and features of a future own econometric study of this link, focusing on similar to Bulgaria EU members (which are also members of the Development Assistance Committee – DAC) members on one hand, and least developed countries (LDCs) from Sub-Saharan Africa – on the other.

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## **Study Rationale: the New Role of Bulgaria in Development Cooperation**

If development assistance is seen as a measure not only to assist developing countries but also as a means of strengthening Bulgarian positions, ties and credibility on the international scene and as a way of creating and strengthening foreign trade relations, Bulgaria could take advantage of it in pursuit of its foreign and external economic policy objectives. This implies the optimal utilisation of the opportunities provided in order to achieve the maximum result both for the recipient-countries and for Bulgaria and its interests and priorities. In this sense, development policy resources should be used purposefully and focused, taking into account the potential economic benefits that can be derived from ODA granting and allocation.

Participation in International Development Cooperation is an integral part of the Bulgarian foreign policy and is carried out in accordance with the common EU policy in this field. In national law, however, this issue was settled only in 2011 by Council of Ministers Decree 234, although relations between Bulgaria and a number of developing countries over the decades prior to the transition period have left a lasting trace in many of these countries, contributing to the economic their development.

From the point of view of Bulgarian participation in the development finance process, its membership in the European Union clearly outlines its donor position. The EU Development Cooperation Policy requires an annual investment of significant funds from the national budget, and the country's obligation related to development finance are long-term and will become larger. Since 2007, Bulgaria as a member of the EU has started to provide ODA, which for the period 2010-2013 amounts to 40-50 million EUR, reaching in the last year 0.10% of GNI. The commitment of 0.33% of GNI in 2017 (or EUR 140 million) is difficult to achieve, but this is characteristic for all new EU member states – none of them is even close to implementing its ODA commitments under the EU Development Cooperation Policy.

According to the Midterm Development and Humanitarian Assistance Program 2013-2015 Bulgaria participates at multilateral and bilateral level, directing its development assistance to countries and regions of priority for the country's foreign policy. In their determination, one takes into account the traditional historical, economic and cultural ties, geographical proximity and political will for cooperation, as well as the existence of specific aid capacities and the EU Enlargement and Neighbourhood Policies. In this regard, as priorities for Bulgaria the Program identifies the Western Balkans, the Black Sea region, the Middle East and North Africa as well as the post-conflict reconstruction countries and Sub-Saharan African countries.

So far, Bulgarian participation in International Development Cooperation is related mostly to financial commitments and capacity building for the conduction of a Bulgarian development policy. There are some positive results in this respect, but in general the country is failing to harness the potential of its participation in International Development Cooperation. To this end, a clear and long-term national development policy should be developed and implemented, the institutional capacity to provide assistance should be improved and the necessary support by the Bulgarian public for full participation in International Development Cooperation should be raised.

In order to support the drawing of recommendations on the strategic priorities which Bulgaria has to set in its participation in the International Development Cooperation, and more specifically – in granting and allocating Official Development Assistance, one must summarise insights and concepts of economic theory dealing with development assistance, mainly regarding the rationale and the potential economic gains of development assistance donors as well as the existence, direction and strength of the link between the dynamics and volume of ODA and international trade flows.

## **The Relation between Development Aid and International Trade: a Literature Review**

In economic development literature on development aid there is a trend for studying both the effects of aid, as well as the rationale for its granting. These issues are interrelated as the reasons for granting aid are often affecting its allocation as well. Many studies show that both development aid and international trade have a positive impact on economic growth and development. This issue will not be discussed here as the study focuses on the economic gains of aid allocation. In

this regard, there is strong empirical evidence that in the case of OECD donors the volumes of bilateral aid disbursements are significantly influenced by bilateral trade between donors.

For a statistical link to exist, aid must culminate in a higher level of donor exports to the recipient than would be the case without aid, or alternatively, the bilateral trade – in particular donor exports, must result in a higher level of aid to the partner than would otherwise be the case.

As noted in many studies of development aid there are many reasons why one might expect to observe a correlation between aid and trade flows from a donor to a particular recipient. In the case of tied aid the link is obvious – the granting of aid is contingent on purchasing goods from the donor. More generally, aid often is given to countries which have strong trading ties with the donor (e.g. ex-colonies). On the other hand, aid could create trade dependency, where recipients purchase imports from donors granting them large amounts of aid because the aid is considered contingent on the imports. Aid could be regarded also as trade creating – it contributes to economic growth in the recipient country that generates a subsequent increase in donor exports to the recipient. Such trade creation benefits the donor, and can be a strong factor in maintaining or increasing the value of aid flows.

Many studies try to identify whether donors tend to allow political and economic goals to influence their aid allocation decisions or whether they instead select recipients on the basis of their objective development needs (Berthélemy, 2006; Fleck and Kilby, 2006; Lewis, 2003; Maizels and Nissanké, 1984; Neumayer, 2003; Schraeder et al., 1998). While existing work suggests that the motives underlying aid decisions are mixed, these studies point to a range of donor interests, such as the maintenance of colonial ties, military alliances, the protection of spheres of influence, and trade and investment ties, as central determinants of patterns of aid flows. (Bueno de Mesquita and Smith 2009; Burnside and Dollar 2000; Dunning 2004; Stone 2008; Thacker 1999).

Most researchers regard the commercial dimension of national interest as a main part of the motivation of donors for aid distribution. National interest of donor countries, reflected in trade ties of the donors with the developing world, represents a consistent benchmark to evaluate the self-interested attributes of aid allocations because the meaning of the concept itself does not vary across donors or over time. One could identify three main motives for donors disburse foreign aid to their trading partners: strengthening export markets, supporting the implantation of donor firms in recipient economies and maintaining access to essential imports. (Lundsgaarde et al., 2010). The relevance of commercial interests as a determinant of aid flows has not been neglected entirely by aid researchers. Schraeder et al. (1998) investigate the influence of commercial interests over aid decisions in their study of aid allocations from four donor countries to African recipients between 1980 and 1989, for instance, while Neumayer (2003) includes trade ties as a covariate in his recent analysis of patterns of aid flows between donor–recipient pairs in the post-Cold War period. McGillivray and Morrissey (1998) place the link between trade and aid at the centre of their analysis of aid allocation patterns but restrict their focus to East Asia.

Aid flows may induce donor exports either because of the general economic effects on the recipient, or because aid is directly linked to trade, or because it reinforces bilateral economic and political links, or a combination of all three. However, according to Lloyd et al. (1998) each of the reasons linking aid to trade can operate in reverse, such that aid reduces trade.

Aid is often linked to the implementation of structural economic reforms (Burnside and Dollar 2000; Easterly 2002; Milner and Kubota 2005), especially the liberalisation of foreign trade regimes (Morrissey, 1995). Trade liberalisation could affect donor's exports, as reduction of trade barriers increases the opportunities for market access in developing countries. Moreover there are various other economic mechanisms through which development assistance could foster bilateral trade – mostly regarding the increase of the import capacity of the recipient country through supporting its economic development (Geddes 1994; Haggard and Webb 1994; Nsouli, Rached, and Funke 2005; Rodrik 1992, 1996; Weyland 2002).

The most direct link between aid and trade is formal tying, where the provision of aid is dependent upon the recipient purchasing goods from the donor – this usually means that aid is provided in the form of goods and services procured in the donor country, thus aid itself is trade (donor exports). In this way aid is used as an instrument of trade policy (Morrissey, 1993). There is a related argument that aid generates political goodwill, from the recipient towards the donor, such that the recipient may feel more disposed, if not obliged, to purchase goods from the donor (Lloyd et al, 1998).

On the other hand there is a lot of evidence on the negative effects of tied aid. Empirical studies have shown that exports provided under tied aid are overpriced, compared to prevailing world prices, by between 10 and 40 percent (Jepma, 1991). Moreover, the goods offered are of low priority to the recipient, are excessively capital-intensive, are highly dependent on Western technologies and are import biased (Jepma, 1989, p. 10). There is also an argument that tying has a detrimental economic impact on donors as tied aid often supports inefficient industries (Morrissey, et al, 1992).

A less direct form of tying is informal, where donors direct aid towards projects, goods or countries in which its own industries have a strong competitive advantage (Lloyd et al, 1998). In practice in this case it is difficult to distinguish resulting trade from competitive advantage. There is a related argument that aid generates political goodwill, from the recipient towards the donor, such that the recipient may feel more disposed, if not obliged, to purchase goods from the donor (Morrissey, 1991).

Even in the absence of tied aid there are ways in which aid can induce recipient dependence on donors for the supply of goods and services – for example, where equipment and machinery are involved, replacement parts are often only available in the original source country (Lloyd et al, 1998). Another example is food aid – some researchers claim that food aid distorts the allocation of resources in recipient countries away from the production of food, thus it distorts domestic consumption patterns and prolongs the very shortages it is intended to overcome (Maxwell and Singer, 1977).

The view that trade can lead to aid (i.e. there is a reverse relation) is generally attributed to effects of aid allocation policies of donors – trade can lead to further aid if donors give preference in the allocation of their aid to countries with which they have the greatest commercial links (Morrissey et al, 1992); when the donor is “rewarding” the recipient for purchasing its exports (McGillivray and White, 1993); when the donor is seeking to consolidate and/or expand its market in the country through the expectation that aid will have a trade-inducing effect (Lloyd et al., 1998).

Cross section data also indicates cases where a negative relationship between aid and donor exports may be observed. A donor may well decide to pursue a more aggressive and indeed risky strategy; rather than focusing on established export markets, it could instead use aid to promote export ties in those countries which currently are lesser markets (McGillivray and Oczkowski, 1992).

There are many empirical studies focused on finding a statistical linking between development aid and international trade (table 1). Despite the claim of most researchers (both in theoretical as well as in empirical studies) that a link between aid and trade actually exists, the fact that many forms of relation are possible represents a problem with existing empirical work: as most studies limit attention to one (or a sub-set) of these possible cases, one cannot draw general conclusions.

A recent empirical study analysing the patterns and dynamics of development aid and international trade of the EU and China with Sub-Saharan African countries (Nestorov et al., 2017) shows that there is no evidence for a causal relation between EU’s development aid (both ODA and TOF) and international trade (both total trade, imports and exports). This is valid both for Africa as a whole and for Sub-Saharan Africa. On the other hand, in the case of China “trade creates aid” – around 55% of the change of aid being a result of changes in foreign trade, the causal relation being stronger for exports.

Table 1

**Does the volume of development aid depend on the volume of foreign trade –  
the answer of different empirical studies (1968-2017)**

Study	Donor	Period under review	Recipient	Answer	
<i>Levitt (1968)</i>	USA	1963	LDC sample	Yes	
<i>Wittkopf (1972)</i>	France	1964	LDC sample	Yes	
		1967		No	
	Germany	1961		No	
		1964		No	
		1967		No	
		1964		Yes	
	Great Britain	1967		Yes	
		1961		Yes	
		1964		No	
	USA	1967		No	
<i>Dudley &amp; Montmarquette (1976)</i>		1961		Yes	
		1964		No	
		1967		No	
Belgium Canada France Germany Italy Switzerland Great Britain	1970	LDC sample	Yes		
	1961		No		
	1964		Yes		
	1967		No		
	1961		Yes		
	1964		No		
	1967		No		
<i>McKinlay &amp; Little (1978a)</i>	France	1968	LDC sample	No	
		1969-70		Yes	
		1967	Former colonies sample	Yes	
		1964-66		Yes	
		1968-70		Yes	
<i>McKinlay &amp; Little (1978b)</i>	Great Britain	1960	LDC sample	Yes	
		1961-70		Yes	
<i>McKinlay &amp; Little (1979)</i>	USA	1962, 1970	LDC sample	Yes	
		1960-61, 1963-69		No	
<i>Maizels &amp; Nissanké (1984)</i>	France	1969-70	LDC sample (former colonies excluded)	Yes	
		1978-80		Yes	
	Germany	1969-70	LDC sample	No	
		1978-80		No	
	Japan	1969-70	LDC sample	Yes	
		1978-80		Yes	
	Great Britain	1969-70	LDC sample	Yes	
		1978-80		Yes	
	USA	1969-70	LDC sample	Yes	
		1978-80		No	
<i>Bowles (1987)</i>	Great Britain	1970-81	LDC sample	Yes	
<i>Bowles (1989)</i>	EC (bilateral)	1975-81	LDC sample	No	
<i>McGillivray &amp; Oczkowski (1991)</i>	Australia	1980-86	LDC sample	Yes	
<i>Tsoutsoprides (1991)</i>	EC (bilateral)	1975-80	LDC sample	Yes	
	EC (multilateral)			Yes	
<i>Grilli &amp; Reiss (1992)</i>	EC (bilateral)	1971, 1980, 1988	ACP LDC sample	Yes	
	EC (multilateral)	1971		Yes	
	EC (multilateral)	1980, 1988		No	
<i>McGillivray &amp; Oczkowski (1992)</i>	Great Britain	1980, 1982, 1983	LDC sample	Yes	
		1986, 1987		Yes	
		1981, 1984, 1985		No	
<i>Gounder (1994a)</i>	Australia	1988, 1990	LDC sample	Yes	
		1987, 1989, 1991		No	
<i>Gounder (1994b)</i>	Australia	1988, 1989, 1990, 1991	SE Asia LDC sample	Yes	
<i>Nestorov &amp; Marinov (2017)</i>	EU	2000-2012	Africa, Sub-Saharan Africa	No	
	China			Yes	

Source: compiled by the author based on Lloyd et al., 1998

## **Future Directions to Be Approached**

In order to draw own results on the link between development aid and international trade through statistical approaches measuring dependencies, the link between the volume and dynamics of Official Development Assistance and foreign trade flows will be tested for a set of selected EU countries, Members of the Development Assistance Committee of the Organisation for Economic Cooperation and Development and a set of selected Least Developed Sub-Saharan African countries. The study will be based on the following limitations:

- The time-frame of the study is 2003-2015, encompassing the new trade relations framework between the EU and African countries.
- Study of development aid will be limited to ODA flows only. Within them it will analyses the volume of gross and net disbursements, not taking into account the relieving and postponing of external debt and the capital investments in public enterprises.
- The member-states of DAC by the OECD are chosen as subject of the econometric analysis as on one hand as members of the OECD they have the obligation to report strictly and uniformly the data on granted by them ODA, while on the other they are the most active ODA donors. Five countries which are similar to Bulgaria in terms of size and openness of the economy, volume of trade flows and commitments to granting development assistance will be selected among DAC members who are also members of the DAC depending on data availability.
- Least developed countries are selected as they receive over 50% of all ODA. The region of Sub-Saharan Africa is selected as on one hand the countries there are among the recipients of the highest volumes of ODA in the world, while on the other hand it is included as a priority region both in the Bulgarian Midterm Program for Development Assistance as well as in the European Development Cooperation Policy. Up to 10 countries which have are among Bulgaria's main trade partners in the region will be selected depending on data availability.
- The specific statistical tools (e.g. cross-correlation, Granger causality, Engle-Granger cointegration, Johansen cointegration) to assess the relation between development aid and foreign trade depend on their results, thus they will be identified in the course of the research work according to their applicability to the available data.

Thus the study will assess the existence, direction and strength of the link between the dynamics and volume of development aid and international trade flows between the EU member-states which are also members of DAC on one hand, and the LDCs in Sub-Saharan Africa – on the other which will support the drawing of recommendations on the strategic priorities which Bulgaria has to set in its participation in the International Development Cooperation, and more specifically – in granting and allocating Official Development Assistance.

## **Conclusions**

Although the aid allocation literature does not provide a consensus on the impact of trade on aid flows, several general types of aid-trade links may exist – first, that no relationship exists at all; second, that trade is a determinant of aid (donors grant more aid to those recipients that import more from them); third, that aid impacts on trade ('aid causes trade'); fourth, that the link between trade and aid is bi-directional (aid and trade form parts of a mutually reinforcing cycle - the presence of one increases the likelihood of the other); and last but not least, that a third common factor is responsible for the observed temporal correlation between aid and trade.

The fact that many forms of relation are possible represents a problem with existing empirical work: as most studies limit attention to one (or a sub-set) of these possible cases, limits the applicability of those studies. Despite the claim of most researchers (both in theoretical as well as in empirical studies) that a link between aid and trade actually exists the literature still cannot draw a general conclusion on its specific features. Thus the further study of this link in EU member-states which are similar to Bulgaria in terms of size and openness of the economy, volume of trade flows and commitments to granting development assistance would allow the formulation of justified recommendations on the strategic priorities which Bulgaria has to set in its participation in the International Development Cooperation.

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