INTERNATIONAL CENTRE FOR ECONOMIC RESEARCH

ICER

WORKING PAPER SERIES

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Working Paper No. 19/2006

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But foreign aid has been a failure.
Lal 2005, 508.

Summary: The main point of this paper is that foreign aid fails because the structure of its incentives resembles that of central planning. Aid is not only ineffective, it is arguably counterproductive. Contrary to business firms that are paid by those they are supposed to serve (customers), aid agencies are paid by tax payers of developed countries and not by those they serve. This inverse structure of incentives breaks the stream of pressure that exists on the commercial market. It also creates larger loopholes in the principle-agent relationship on each point along the chain of aid delivery. Both factors enhance corruption, moral hazard and negative selection. Instead of promoting development, aid extends the life of bad institutions and those in power. Proposals to reform foreign aid – like aid privatization and aid conditionality – do not change the existing structure of the incentives in aid delivery, and their implementation may just slightly improve aid efficacy. Larger improvement is not possible. For that reason, foreign aid will continue to be a waste of resources, probably serving some objectives different to those that are usually mentioned, like recipient's development, poverty reduction and pain relief.

Foreign aid has not existed throughout history as it is plasticized today, aside from a few sporadic events that may have resembled it.[1] Countries in need looked to commercial credits rather than to have waited on aid. Foreign aid emerged as a part of the post WWII order, as one of the instruments to promote development, relieve pain and alleviate poverty.[2] The emergence of aid on the international scene is inseparable from the popularity of the heavy hand of state in the domestic economy of relevant states. When planning, regulation and social engineering became the instruments in internal economic policies of larger developed states, it was a natural step to implement the same tools on the international scene. Institutions for such programs were missing, since the WWII wiped out international organizational infrastructure that had existed before. The epidemic in designing international organizations after the WWII was motivated by creating international means for interventionist policies rather than by sheer re-establishment of their rare pre-war equivalents. In addition to international development agencies like the World Bank, IMF (International Monetary Fund)[3], EBRD (European Bank for Reconstruction and Development) or UNDP (United Nations Development Program), all larger countries established their own agencies for implementation of development aid.

It seemed easy to make the case for foreign development aid in the post-war institutional environment. Developed countries could help non-developed countries largely at a negligent cost, it was stated[4], if they allocate a very small piece of their GDPs. By getting foreign aid, non-developed countries will probably not catch up, but at least they will avoid larger troubles and speed up development.

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[1] By working on this paper I have enjoyed the generous hospitality of the ICER, Turin, Italy. I would like to thank Milic Milovanovic, Belgrade University, and Suri Ratnpala, University of Queensland, Australia, and Slavisa Tasic, Ph.D. candidate, for helpful comments. The responsibility is exclusively mine.

[2] "There was no development aid until President Truman's Point Four in 1949. That led to foreign aid and that led to development economics". Peter Bauer in: IEA 2002, 35.

[3] The IMF initially had a role of policing monetary order and in 1970ies it assumed its development role.

[4] "Foreign economic and humanitarian assistance programs make up less than one half of one percent of the U.S. budget. This small contribution by the United States makes a big difference around the world." Cf. Atwood, 1995.

This idyllic picture of foreign aid prevailed during several decades after the WWII, and it started to pale just recently under the influence of articles and studies that called into question the nature, justification and efficacy of aid. On the one hand, it took a long time to collect empirical evidence, and, on the other, it took some time to get the courage to attack something that was considered to be a sound part of the international order, which was not before seen as objectionable. For eminent economists over the past several decades, foreign aid was not an interesting topic. Academic economics has ignored the subject because it seemed to be of a practical rather than of an academic interest. With rare exceptions, first class economists began to deal with foreign aid just recently when the shift in its understanding was already on the way. If any particular contribution to this shift is to be mentioned, it would be the work of the late Peter Bauer[5]. While dealing with foreign aid for his entire life, he was the first to write systematically on the weaknesses of aid delivery. There is hardly a single argument questioning the rationale of foreign aid that was not mentioned by Lord Bauer. After Bauer, it is easier to see that foreign aid is ineffective because it resembles central planning. The contribution of this paper is not in declaring a similarity of aid to central planning, since we have seen such statements by Bauer, Easterly, Friedman or Lal. I will try to go further in two directions. First, I will compare the structure of incentives for market operations to those for aid and planning. My question is what are the incentives for aid workers to get things done. Second, I will suggest that foreign aid is not just inefficient – it is also counterproductive.

Types of foreign aid may be very diverse, and I do not have all of them in mind when writing this paper. Excluded are the types of aid like those covered by a humanitarian intervention, diplomatic and political aid, the aid through trade and preferential agreements, and debt service write offs. My article is focused on foreign development aid in its narrow meaning where one constituency helps another by granting goods and services, financial transfers and technical assistance. The total amount of foreign aid was more than $ 2,3 trillion over the last five decades.[6] The size of the aid in the narrower sense in the world is estimated to be $60bn per year at the beginning of XXI

[5] For example, Bauer 2000. See also Brumm 2003, IEA 2002.
[6] According to Easterly 2006.

century. This amount is equal to some 20% of foreign direct investment in non-developed countries.

Despite the fact that foreign aid accumulates significant means and that it has been practiced for decades, there is a growing attitude among researchers that the aid has no tangible, long-term impact on economic development. In conveying this result, some authors are more refrained (Swenson & Dollar; Easterly 2003) while others are very outspoken (Boone 1994; Lal 1996 and 2005; White 1992; Martens et al. 2002; Easterly 2006, Djankov et al. 2006).

Facts are the driving force in this change of attitude. William Easterly[7] led a larger research using the data for 88 countries supported by the World Bank and found that in just six cases, aid had some positive visible influence on growth. More specific in its conclusion was the single largest donor – the U.S. – when it concluded the following, after reviewing its long history as a donor: "The U.S. has granted $ 144bn in inflation-adjusted dollars to 97 countries in the period 1980-2000. These 97 countries had a median inflation-adjusted per capita GDP of $1,076 in 1980 but only $ 994 in 2000, a decline in real terms".[8] Among these 97 countries "…37 averaged zero or negative growth in per capita GDP from 1980 to 2000. Another 27 averaged marginal growth rates between 0 and 1 percent over the span. And only 33 averaged growth in per capita GDP over 1 percent from 1980. to 2000, of which only three (St. Kitts-Nevis, South Korea, and China) averaged over 5 percent".[9] Djankov et al. go a step further and state that aid has a negative impact on recipients: "… foreign aid has a negative impact on the democratic stance of developing countries, and on economic growth by reducing investment and increasing government corruption".[10] All three researches are based on large samples and all state that there is no long-term positive influence of foreign aid on growth and the standard of living. Under the pressure of such results, the U.S. decided to reshuffle its aid programs in such a way that the aid inflows are related to reform efforts in the recipient

[7] Cf. 2003, p. 32-33.

[8] Cf. Schaefer 2002, p. 1.

[9] Schaefer, 2002, p. 3. Korea has grown due to liberalization of the tradable sectors, while China has grown due to a combination of *de facto* privatization of agricultural land and larger liberalization in the free trade zones. The case of St. Kitts-Nevis is poorly researched.
[10] Djankov et al. 2006, 2.

country. This program is called *Millennium Challenge Account* (MCA). The UN commission, chaired by Jeffrey Sachs, has developed the MDG (*Millennium Development Goals*), a close relative to the MCA. I will comment the proposed changes at the end of this paper.

MARKET VS. PLANNING

The majority of studies on aid was focused on the effect of aid in the recipient countries. These studies have pointed out the lack of institutional infrastructure, different social habits and low level of development as the main obstacles to efficient aid delivery. Some among these studies sound reasonable and well grounded. It may be that these factors from the recipient side contribute to the inefficiency of foreign aid. Contrary to common wisdom, I will focus on the side opposite to recipients – on donors. I do so because it is irrelevant what happens at the recipient side if the instrument on the donors' side is misconceived. If so, the responsibility for its ineffectiveness rests solely on donors and there is nothing recipients can do to change the situation. We will also see that it is the nature of operation of aid that implies a particular structure of incentives that causes its inefficiency. In order to realize the former statement, let us compare the operation of the market, i.e. the business firm versus aid delivery.

A business firm opening a branch office in a foreign country may face a different business and social environment, but its main objective remains the same throughout the landscape – making profit. The functional structure of a business firm is performs as usual; business people get revenues from those for whose goods they are supposed to produce. *Microsoft* serves customers around the globe and gets revenue in exchange for services. In doing so the firm needs to survive competition – to pass the test of the market. A firm's headquarter continues to check the operation of its branch office in a foreign country in the same way in which it controls its domestic offices. Market pressure does not allow a business firm to relax its monitoring and controlling activities. Any relaxation of usual controls may result in loss of revenues and profits, and this would impose damage to a firm's owners.

Consider now the case of foreign aid. Its main objective is to provide development assistance to some foreign country. Voters from the country providing means for aid are not those that profit from aid. Donor's voters may feel some moral satisfaction for offering aid to people in trouble, or enjoy some externalities from a poor country's development, but they are not the beneficiary of aid. Aid workers are not paid by those for whose benefit they are supposed to work. By serving some population aid agencies, contrary to business firm, get nothing but gratitude in exchange. They grant rather than sell. They serve the population of some troubled country, but they are paid by tax payers of developed countries – an inverse structure of compensation compared with that of the business firm.[11] By not being paid by and dependent on those served, aid workers are relaxed from the operating pressures in the same way in which planners were relaxed from those "those who were subjects of the plans".

When one buys a *Fiat*, he does not need *Audi*, *GM* or any equivalent car. On the contrary, when one gets aid from the agency X, this does not exhaust the place for aid from the agencies Y, Z or W. In other words, market demand is limited by financial means available, while aid absorption capacity is not. More precisely, it may be limited only by a donor's readiness to grant aid rather than by any trait of the recipient. Aid has a cost next to zero for the recipients, and they take it all.

A business firm is very interested whether customers are satisfied, while aid workers do not have incentives to care whether aid recipients are satisfied. Aid workers need not care about recipients' satisfaction because they are sure that recipients will always accept aid when it is offered, due to its low cost. Neither aid nor planning are exposed to competition, and this indicates that they are mutually similar as non-market phenomena. Like central planning, aid is centrally collected and allocated according to the plan created in advance, regardless of circumstances in the recipient country and regardless of its effects. Plans for aid are tailored by one entity, while the costs are born by another. Planners and aid agencies are paid by governments (donors) rather than by customers. Consequently, customer satisfaction (aid recipients) is irrelevant for the

[11] This inverse structure has nothing to do with the type of ownership. Nothing would be different if donor organizations were private instead of state owned. Just exceptionally aid is collected and allocated by private, for profit firms. Private firms are, however, frequently involved in consulting and other sub-contractual deals.

government (donor), and there is no need for proper feedback information. Instead, there is a feedback loophole that is also typical for central planning. Contrary to a business firm where feedback information is important because it informs producers on how products are accepted in the market, an equivalent feedback information in the case of aid is useless, since all aid is accepted due to its low cost rather than its quality. This completely frees the hands of those reporting on aid delivery.

Having all that in mind, it is not surprising that foreign aid fell under doubt as an endemic trace of the past after collapse of communism. "Seventeen years after the fall of the Berlin Wall, there is just one major area of the world in which central planning is still seen as a way to achieve prosperity – countries that receive foreign aid".[12] Milton Friedman witnesses that central planning was deliberately introduced rather than organically emerged. "Again, conventional wisdom in the development community was that you needed central planning. If the underdeveloped countries were going to get anywhere, it would only be through central planning".[13]

Ineffectiveness of aid does not mean that all development aid operations must fail. Some aid operations were and are successful or partly successful. This means that they have achieved their objectives and improved the situation. However, this does not prove the case for foreign development aid, because successful operations are not numerous. Under central planning some successful firms also existed due to different factors – like protection by the state, insufficient competition, limited supply of the good produced, etc. But they were just a small fraction of the economy and unable to reverse the fate of the whole order.

Similar to central planning, the profile of aid delivery is complicated because it reflects the complex organizational structure and correspondingly creates a complicated, inefficient structure of incentives. A state, represented by politicians and bureaucrats, decides on behalf of its voters to grant aid to some foreign country. By doing so, the aiding country uses some specialized agency for aid delivery and the specialized agency eventually engages subcontractors for the execution of the aid program. Since the state with its agencies is not exposed to the pressure of market forces, other mechanism

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[12] Easterly 2006, 2.
[13] M. Friedman in: Friedman & Sowell 2005, 442.

of control is needed. In the standard scenario, politicians issue commands and they should control and monitor how commands are obeyed. The absence of market or other equivalent pressure, owing to the structure of incentives, allows weakening of the command and monitoring mechanisms that cause significantly different results of foreign aid when compared to foreign or domestic private investment. This distortion occurs along the chain of command from voters of the granting country to voters of a beneficiary country. Aid workers and agents in general are supposed to work in a certain way, although the structure of incentives allows quite another action. Aid workers, like planners, may have good intentions, but they are not really motivated to implement them. Even if they were personally motivated, they would face an inappropriate structure of incentives. Aid workers launch plans and raise expectations but do not bear responsibility (consequences). Like managers in state-owned firms, they do not bear responsibility for their choices because enforcement and monitoring cannot reverse incentives nor repair the damage. They engage in creating additional deception in order to present a rosier picture that everything goes well.

Along the chain of aid delivery, there is an uneven, asymmetric relationship of competence and information, again similar to central planning. As a rule, actors located lower in the chain (beginning with voters and politicians in the aid granting country and ends with local agencies, aid suppliers and voters in a recipient country) are privy to significantly better information compared to actors located higher in the chain of aid delivery. While taxpayers and politicians in the aid granting country depend on second-hand information provided by media and their intermediaries, aid agencies, subcontractors and local agents have first-hand information because of their day-to-day involvement in project implementation. Nevertheless, competencies in planning and decision-making concerning vital questions of aid are concentrated at the other end of the chain. They are placed where the information is poor – in the hands of politicians of the aid granting country. All important questions – like the nature, size, type, objectives and duration of aid – are decided by politicians and aid agencies, i.e. those that are inferior in information compared to their subordinates along the chain. The same happened under central planning – planners were not interested in real circumstances and how those affected by planning feel and what they need. The above has at least two important consequences. First, decisions related to aid supply can not be optimal or adjusted to the situation. Second, there is no proper feedback information.

In addition to these incentive and information problems with aid delivery, foreign aid in the world has undergone a change that enhances the space for manipulation. When the World Bank was established, its main objective was to promote investment, growth and development in poor countries. Socialism was popular in the East and in the Developing world, while in the West, the atmosphere was friendly to increasing government regulation, and welfare state policies. So many of the Bank's activities moved around direct investment in poor countries in infrastructure, factories and farms. The results were much poorer than expected. Over the years, the Bank has redefined its main objective from promoting development to "fighting poverty" or "poverty reduction". The shift occurred in 1980s with the focus on institutional reform rather than on investment. Other larger world donors have followed the Bank by redesigning their aid programs.[14]

The reasons for this fundamental change were twofold. First, growing awareness among donors that poor countries lacked a suitable business environment and that investment under present circumstances was equal to squandering resources. One may wonder how it was possible that aid and other authorities in developed countries were not aware of the problem before or shortly after the aid programs started and why they wasted resources for decades before discovering that such programs were failures. Secondly, by shifting away from the prevailing belief in planning to belief in market forces, investment activity of state and non-market funds was progressively considered non-productive. This redefinition of the Bank's role, followed by other larger aid agencies, clearly indicates the failure of the development philosophy from the early period. With the demise of donors' role in development, which was clear despite its basis on irrational expectations, donors shifted to institutional reform. However, this is not only more difficult but also a much less clear task. Development was relatively easy to measure via conventional data. But how can one measure "institutional development" or "building institutional capacity"? This change of strategy toward ever-increasing vaguer

[14] Some aid programs, like *Phare* and *Tacis*, that were launched in 1990s by the European Union, were institutionally focused from their inception.

objectives is not original. Central planners did the same. When one strategy collapsed, they proclaimed another fuzzier one, thus buying additional time at a lower cost.

It is straightforward to realize that donor actions after the change of strategy were exposed more at will than before, what has again additionally freed the hands for manipulation of all actors along the aid granting chain. Post-contractual uncertainties rose sharply, risks of moral hazard and adverse selection became higher, corruption opportunities were enhanced, while monitoring and evaluation got new ground for “creativity”. “Creativity” consists in depicting disasters as success stories. In a word, the whole game of granting aid became less accountable than before.

THE CHAIN OF AID DELIVERY

Voters and politicians. Similarly to central planning, the means for aid are first centralized and then disbursed. When politicians in aid granting countries, acting on behalf of their voters, decide to grant aid to some country, they both *prima facie* believe that this will improve the situation. There are a variety of reasons behind this conviction. One may feel that aid contributes to growth. Others may believe in improving the institutional structure of the recipient country. Many would like to relieve suffering among the population in a country. Taxpayers in developed countries, when confronted with pictures of the poor, may feel compassion, solidarity and prepared to help the poor. Additionally, aid suppliers and consultants would like to get new contracts and to earn additional money on external market. Finally, politicians may like to export values and home products by distributing aid. Whatever the reason, a decision to grant aid is hardly objectionable. Readiness to help others is not just legitimate but even desirable. However, good intentions and desires do not necessary lead to good results. In order to make a nice generosity translate into a good result, one needs the appropriate instruments. This is precisely what is missing in the aid delivery chain because of the structure of incentives.

Political room to maneuver with information on domestic transfers is relatively restricted since some voters are beneficiaries of transfers, while the rest of voters may at least sporadically monitor what is going on. There is no such feedback when it comes to foreign aid. Beneficiaries of transfers are foreign citizens. If it holds that politicians, above all, focus on their domestic interests, the interest for foreign aid may be merely instrumental, and if there is no opportunity to present the case for domestic purposes, foreign aid may be worthless for politicians. Politicians are controlled by their domestic terrain, those actions that they take on the behalf of voters, but this is largely much too difficult to account for in their actions abroad. Instead of pursuing voters' preferences, politicians may deviate from expectations and advance their own interests. Politicians also may have some information about target country that is not available to voters and manipulate it against voters' interests. Aid may be used to simply shift attention from painful topics of internal policy toward foreign policy. Aid may be used as a pretext for a humanitarian or military intervention, to support or suppress some political forces, and that again may be different from voters' preferences. Politicians may travel to a distant target country pretending that they care about aid delivery. It is costly for voters to find out the truth about such trips that abound in corruption opportunities. In the end, aid may be used fairly to help those in need, but this depends more on the aid agency and not the politician.

Politicians and aid agency. Contrary to private, for-profit firms that have only one objective – profit – aid agencies usually have multiple and hard-to-define objectives. There are umbrella objectives and specific objectives and both are vague and multiple. Under umbrella objectives are to be found: pain relief, development promotion, combat poverty, building institutional capacity, strategic planning[15]. Specific objectives range from supplying food, building hospitals and schools, graveling roads, preventing disease, supporting institutional change (like privatization or legislation proliferation), supporting entrepreneurship, enhancing education, etc. The structure, timing, priorities and ways to conduct such actions may be very different. Multiple objectives and different opportunities for aid delivery weaken both the connection of aid delivery with umbrella (political) objectives and the procedures of monitoring and evaluation of aid delivery. Unlike a business firm, it is difficult to establish an efficiency measure of the aid agency's activities. Multiple objectives often operate against each other and weaken each other, so that aid may end up serving none of its multiple goals particularly well. An aid

[15] After demise of central planning, strategic planning became its replacement applicable at the regional and local level.

agency may obfuscate its objectives and manipulate results (performance) in order to avert investigation and prevent insight into real achievements. In order to cover multiple and frequently conflicting objectives, administrations and aid agencies label these programs with slogans like "aid, not trade", "Beautiful Bulgaria", "first things first", "alleviate poverty", "Serbia on the right path". This merely focuses the public's attention away from real problems and troubles in execution of aid programs.

The wider the range of political principles and interest groups to which the politicians and aid agency have to respond, the vaguer will be the aid mission, the weaker the constraints and the more diversified and complicated the structure of incentives will be. International aid organizations, such as the UNDP, World Bank or EBRD, have an additional problem of reaching consensus over objectives, due to their joint delegations. These usually result in costly negotiations and mutual concessions that, as a rule, end with even weaker and fuzzier objectives than in the case of national donors. The control of international programs is also weaker than in the case of national ones, again due to the joint delegation of responsibilities.

Aid agency, subcontractors and consultants. One may feel that there would be fewer problems as the implementation goes down the chain, from politicians via aid agency to subcontractors. This expectation is unfounded since the problems continue to persist. "Following Gresham's law, 'bad suppliers will drive out good suppliers'. On average, suppliers who take more risks and make less effort to achieve project objectives, stand a higher risk of being found out. But that risk becomes verifiable *ex post* of contract signature only and often *ex post* of project implementation, when it is too late and/or very costly to correct implementation problems. There are basically two ways to reduce these post-contractual risks: to invest more in *ex ante* information on the quality of the bidders or make it exceedingly costly for them to take implementation risks".[16] However, both hopes for improvement fade away as one takes a closer look. In order to get better suppliers, additional research is needed. The more one invests in additional research of this type, the more accurate information he will receive. It also holds, the more investigation conducted on aid delivery, the more interest subcontractors will have to invest in order to distort the information, by presenting themselves and their works in a

[16] Martens, 165.

better light than they *de facto* are. Negative selection sometimes makes additional research pointless. Frequently one gets just two or more bidders that are good or bad to a similar degree. Their only interest is to get the job and to acquire profit, this time in exchange for nothing, since aid agency is short of incentives to check how subcontractors operate. Even if it appears to be an honest bidder, the reality is that there is nothing like this because such a bidder has already been expelled from the business as a disruptive factor that has a higher operation costs and lower profit. This would merely unsettle the aid agency because it raises the risk of honest reporting, which again may shed undesirable light on the whole aid operation, i.e. on its ineffectiveness.

Another option for an aid agency would be to improve performance evaluation. This may include several different measures like reducing implementation uncertainties and implementation risk, close monitoring and reliance on a really independent evaluation. This is going to be not only exceedingly costly but also undesirable, as I will show later on by discussing the evaluation risks.

It is sometimes said that aid officials quickly rotate out which minimizes the effects of the learning-by-doing process. Such fast rotation may play some role in explaining aid results but just to some modest degree. The salary policy offers a much better starting point for the performance explanation. Salaries in aid agencies are fixed because it is impossible to measure aid performance. They are fixed extra high because such salaries are considered to be a "hardship allowance"[17], although in reality there is nothing hard or dangerous. As a rule, salaries in aid agencies are much higher than that of the staff in local administrations, where they are fixed as well. This means that international aid agencies would be able to save a lot of money spent on salaries, but they are not interested in such a saving strategy. This again indicates that salaries are present rather than compensation for work effort. Fixed salaries do not encourage risk taking and work ethics. When pay is not related to performance indicators, it is impossible to improve incentives for a better performance by shifting salaries up and down. Local bureaucrats may be additionally discouraged to facilitate execution of aid programs

[17] I met in Belgrade in 2002 an official of one larger international development organization, aged 29. His mission was to visit Bosnia and Herzegovina, Serbia and Kosovo. He was simultaniously paid $ 1500 per territory per day, what means $ 4500 per day, plus one daily allowance of $ 1000, exceeding five times the accommodation costs. For 28 days of his „mission" he collected $ 146,000 and all that was tax free. It was against the rules of that organization to get more than one honorarium of $ 1500 per day.

having seen that aid officials are paid several times higher[18] than they are for a work that local officials consider as a useless squander of money by careless, arrogant, ignorant and sometimes even insolent persons. Nothing would change if aid workers were ordinary people with exception of disappearance of non-necessary irritation. Aid workers are short of motives for work effort and of instruments to induce local authorities and other stakeholders to assist aid programs, with exception of those domestics that are net beneficiaries of aid, and these are rare. Central planning was inefficient in enforcement although it disposed over heavy instruments to discipline subordinates like the communist party, regular and secret police. Constitutionally constrained government granting aid is short of such instruments. By lowering the price for offenses, the threat of sanctions is undermined. News about the criminal prosecutions of politicians and aid workers for the misuse of aid funds is so rare that it deserves to enter the headlines.

Target country, local agencies and target groups. Among the justifications for foreign aid, the "vicious cycle of poverty" or "poverty trap" are the most popular and have been championed for a long time.[19] Poor countries are poor because they cannot generate capital. Consequently, they cannot develop, thus keeping them poor. The current trend of thinking to believe that only way to eliminate this poverty is to bring capital from the outside. If one assumes that this is so, how can be explained that once poor countries, which are now developed, have ever developed? The main problem is not whether some country is poor or developed; the question is does it have the institutions that encourage capital formation, investment and entrepreneurship. The problem of the African countries is not that they are poor or that they do not get aid enough. Their problem is that they rely on socialism rather than capitalism, and with foreign aid they receive more socialism. Lord Bauer and many others wonder why governments pursuing anti-market policies that economically cripple their countries get aid. The above explains the paradox. Aid based planning comes in support of its domestic ally, resulting in a stagnating or deteriorating situation. For that reason, aid agencies cannot indicate any improvement over decades, as

[18] Sometimes salary differentials are offending. The chief of one international program for South Serbia 2001-2005 had a monthly salary 52 times higher than the Serbian average. His deputy (local staff) had 24 times higher salary than average, local activists 10-12, drivers 6 times, coffee girl 5 times – the lowest salary in the local office.
[19] Although this justification has been discredited for a long time, Sachs (2005) and the UN MDG-program are based on it.

the World Bank cited in reports in footnote no. 32. The solution for poor countries is to rid themselves of foreign aid and to enforce property rights, freedom of contract and open their markets.[20]

Another prejudice is the myth that aid is a win-win strategy. Donor country or agency asks a recipient to do something what is in the recipient's interest in exchange for getting aid. It seems that recipient profits twice. It profits once by doing something that is in its' interest, the other time by getting aid. This win-win strategy seems to be predestined to succeed.

This requires shedding more light onto the idyllic win-win strategy. Let us go back to the beginning and ask: who decides what is in recipient's interest? This is usually done by donors in a similar way in which central planners operated. They estimate what is supposed to be in the recipient's interest. Donors select what is in recipient's interest, although they do not bear the consequences of their choice. Planners also decide on others' fates without being affected by the consequences themselves. The cost for central planning is borne by state budgets or foreign creditors; the cost for aid is borne by the taxpayers of rich countries and the recipient. No wonder the recipient, when struck with such an uneven structure, is frequently either indifferent or against such imposed choice. Recipient may reject donor's choice even when it is a reasonable one. Rejection may be caused by a different perception of priorities and different interests. It may reject objectives and accept aid. It may accept both the objectives and aid, which again does not guarantee a successful implementation of the aid program.

All Central and East European countries (CEECs) after the collapse of communism were populated by the same density of foreign aid workers delivering technical assistance. All of these countries suffered from the same disease. In every case, the advice was the same – do some kind of pro-market reform. Due to the fact that CEECs' situations were similar, one would conclude that the post-reform outcome should be similar, too. This would be wrong. Although the situation and density of experts were similar, the outcomes were widely divergent. Some countries did fast, deep and consistent reforms and became reform champions. Others have seen moderate reforms, and the third ones were the latecomers. The conclusion is straightforward – foreign

[20] As Mart Laar succinctly said citing Peter Bauer – "Trade, not aid".

expertise has no greater positive impact on reform in CEECs. The reform exclusively depends on the domestic political elite and given circumstances. Only insiders may be a factor of reform. Not only has foreign technical aid not contributed to reforms in the CEECs latecomers, it may have actually slowed down reforms in reform champion CEECs by suggesting welfare measures, bureaucratic interference into economy, slow pace liberalization, and control instead of competition.[21] For example, all candidates for the European Union from the CEE were urged by the European experts to raise their income and corporate profit taxes in order to finance the welfare measures comparable to those in over-regulated EU15. Instead of home-grown regulation and central planning, a similar imported process developed under umbrella of "technical assistance".[22] Instead of getting rid of the socialist past, technical and other aid slowed down the change of the rules of the game and in some countries, even repaired and fixed the already shaken socialist heritage. As in the case of Africa, technical and other aid in the CEECs restored socialism[23] or slowed down its demise[24], rather than acting as an impetus to capitalism.

The above explains the paradox that the CEECs championing in reforms (Baltics, Czech Republic, Hungary) have received rather symbolic financial aid, while those that were latecomers (Balkans, Ukraine) obtained large financial transfers. Larger transfers discourage reforms. Transfers have temporarily improved the standard of living and macro-economic stability, but they failed to inspire institutional change. Aid raises moral hazard both by reducing readiness for reform and by undermining incentives to invest. Aid reduces readiness for reform because it spreads the message that improvement is possible without reform (due to aid) and foreigners, rather than domestic actors, will improve the situation. By getting a significant amount of foreign aid the recipients, believe that future troubles and poverty will induce future aid.[25] In addition, foreign aid makes government stronger, and in many underdeveloped countries, government was already too strong or even dictatorial.

[21] Deepak Lal 2005.
[22] To be fair, current technical assistance resembles more to central over-regulation than to planning; just a smaller fraction of technical experts still believes in planning.
[23] Examples are in Bosnia and Herzegovina, Serbia, Montenegro and Macedonia.
[24] Examples are in Poland, Romania and Slovenia.
[25] Let us put aside the standard objection that aid finances consumption rather than investment, since the investment conducted by state and non-market funds is notoriously inefficient.

One of the popular trends in aid delivery is to blame the recipient for the failure of aid. Recipients are blamed for being lazy, inactive, disinterested, corrupt, and without appropriate institutions or understanding of the aid objectives. It is not a secret that this description frequently fits into the situation. Taking a different approach, donors are the one who actually have insight into the situation of the target country even before they have decided whether or not to go there. If they have not provided enough information, that is their failure rather than that of the recipient. This picture, where only recipients are blamed for the failure of aid missions, existed merely because the world press shared the prevailing view that donors are good and that only recipients may be at fault. In fact, all important decisions and instruments are in the hand of donors. Over time, the verdict of blame for aid failure shifted away from "blame the recipient" to a "blame both sides". It seems that another lapse of time is needed in order to get courage to locate the main responsibility on donors.

Aid to corrupt regimes is also as problematic as aid to governments conducting anti-market policies. Its size and frequency show that this does not happen by chance. "The world's 25 most undemocratic government rulers (out of 199 countries the World Bank rated on democracy) got a sum of $ 9bn in foreign aid in 2002. Similarly, the world's 25 most corrupt countries got $ 9,4bn in 2002. The top 15 recipients of foreign aid in 2002, who each got a more than a billion dollars each, have a median ranking in the worst fourth of all governments everywhere (ranked in democracy, corruption, etc.)".[26] It is impossible that donors are not aware of where their means end. One option would be that they eventually deliberately work with corrupt regimes because this enhances corruption opportunities inside the aiding agency. Another option would be that these 25 regimes are among the poorest and that bureaucrats do not care that they are extremely corrupt, too. Experts calculated "that between $26bn and $130bn of money lent by the World Bank for development projects since 1946 has been misused".[27] Such a massive misuse of funds cannot coincidentally happen. Even more surprising is that aid agencies have rules stimulating corruption and manipulation. Like the UNDP and WB, rules prevent staff in nearly all aid agencies for testifying in public, including public hearings.

[26] Easterly 2006, 18.
[27] Cf. Carol 2004. The estimate is in 2004 dollars.

This is a blatant contradiction of the aid agencies' demands on poor countries to operate transparently.

By knowing that monitoring is not precise and tight and that evaluation will be friendly, donor organizations do not need to hesitate to spend resources without a careful analysis of the situation and selection of methods and targets. Once they enter some country, they may like to pursue their own[28] instead of a recipient's interests. But whatever they do, they became a hostage of the situation. Choice is reduced. If they eventually decide to leave a country, this will be booked not just as a donor's failure but as a failure of all persons involved in aid delivery, damaging their careers. For that reason, an exit option is merely reserved for situations where it is obvious that there are some huge and visible obstacles to the continuation of aid delivery. In fact, situations where aid delivery is questionable, if not ineffective, are much more numerous that these clear situations with obstacles. In such situations donors continue with aid, since this option is perceived as less troublesome. The explanation for this is simple. Social or political embarrassment is delayed, if not averted, and there is a chance to influence and bias the report.

By being similar to central planning according to the structure of incentives foreign aid is also similar to planning in achieving poor results. Central planning, as experience shows, has never ended poverty. It was implemented at home while foreign aid programs are implemented abroad. This distance just deepens the failure. By anticipating that aid design and aid results widely diverge, all intermediaries along the chain have incentive to keep the information on low profile and even to bias it according to the need. No wonder that the aid performance and reactions of beneficiaries sometimes are manipulated to such a degree that they are beyond the recognition.

MONITORING AND EVALUATION OF FOREIGN AID

[28] When the World Bank decides to pay out adjustment loans, despite the fact that in one third of cases countries fail to implement policy targets, it happens because the Bank worries about the country's ability to service previous Bank or other loans. Debtors hardly may fail to notice aid supplier's lack of commitment to its own commitment. Cf. Dollar & Svensson 1998.

Because central planning was ineffective, evaluation and reporting were extremely sensitive and important. Their main task was to manipulate results heavily, so disasters were depicted as success stories. Eventual negative reports on planning were highly undesirable or even prohibited. Central planners never conceded that their five-year-plans had failed. They used a totalitarian state that provided coercive means to spread lies and capture information. By the same token, foreign aid continues the practice of mass deception through reporting and evaluation. However, it is much more difficult to mimic the manipulative habits of central planning in a constitutionally constrained democracy.[29] Despite the fact that aid agencies are exempt from domestic rules and that their inspection and investigation is restricted in different ways, their results are publicly visible, and as such, a legitimate target of research.

An inverse structure of incentives in conjunction with political and geographical separation between taxpayers and beneficiaries make it difficult to monitor and evaluate aid performance feedback process. A broken feedback loop enhances the space for manipulation.

Donors or taxpayers judge the work of an aid agency exclusively by its public image and public pronouncements. Politicians control aid agency by reports that are written either by agency officials or by independent consultants. In many organizations, the task of evaluation is conducted by persons directly involved in projects, like officials of the aid agency itself, so that they can not be considered impartial.[30] It is clear that insiders cannot be relaxed from their values, objectives and interests. They may have enough information, while being insiders, but they have an interest to reduce or to intentionally neglect negative information and to overstate positive information. They will tend to produce reports favorable to their past dealings in order to justify their activities and to enhance prospects for their future careers.

But even in those cases where evaluation is conducted by some third party, there are severe problems. Imprecise, 'woolly' and basically useless reports emerge for

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[29] Researchers that do not share optimistic view on aid face similar obstacles to dissidents under communism. Officials and aid agencies make for them difficult to get the information, declare them not eligible for grants and rents, discourage publication of their works, react with silence to criticism. Nevertheless, authorities cannot stop, imprison or kill unorthodox researchers, as it happened to dissidents.

[30] The advisory commission, set up by the U.S. Congress and chaired by Alan Meltzer, recommended, among other things, that the aid agencies like the World Bank undergo an independent evaluation. Despite this, independent evaluation in the WB did not took place yet.

several reasons. First, when a firm/organization gets an evaluation contract it is short of incentives to search for more detailed information. The search is costly and any further search is financially consuming while the reward/revenue is already fixed by the contract. Secondly, a firm operating at the limited evaluation market should not upset the market with a truth-telling report, thereby loosing its foot in that market in the future. Having seen at least ten dozen of evaluation reports during past fifteen years, I was surprised by how they all look similar[31] to each other, even though they were written by different organizations and authors. Based on experience, one can say that the ideal evaluation report has the following main features:

1) The report should repeatedly point out that the aid program has achieved its starting objectives and frequently that this is done beyond the initial expectations.
2) The report is based on the evaluation of inputs rather than outputs. This makes it possible to concentrate on good intentions and means used rather than on the efficiency of resource utilization.
3) Statements in the evaluation report are broad and general enough, while precise and accurate information is avoided.
4) Wording, statements and the general spirit of the report should not disturb any interest group or particular important person. A violation of this rule may result in additional investigation inspired by such a group or person.
5) Heavy criticism of the project execution is to be avoided at any price. The modest, tempered and general criticism may be welcome, especially if it is related to broad or peripheral topics.

[31] It seems that this type of similarity appears more frequently, as a result of similar structure of incentives: "I was working with a few colleagues and consultants on the two global performance reports of the EC-financed Phare and Tacis… We have worked our way through a pile of monitoring and evaluation reports on individual Phare and Tacis projects… **While we were compiling a synthesis report, we were struck by the convergence of views that emerged out of this apparently chaotic pile of information. There were many similarities in project design, implementation and outcomes, in behavior of project managers and policy decisions, despite a wide diversity of project circumstances, across countries, sectors and types of projects. Evaluation reports on EC programmes in other regions of the world revealed similar patterns**". Martens et alii 2002, p. 2-3. Emphasize is mine. Not to forget that Martens and others acted as the EU super-evaluators and that they were obliged to be as polite as possible in order to avoid that their report inspires a larger embarrassment.

6) Humor, irony and cynicism are to be avoided. A sterile bureaucratic language with the pro-active formulations, as well as politically correct language is strongly encouraged.

One cannot say that the writers of evaluation reports are born con-artists or illusionists, but they become like that by realizing circumstances and incentives of the evaluation process. Evaluation is highly decentralized and so reports cannot be coordinated to look similar to each other. If they, nevertheless, look similar, it must be the result of similar constraints. False or 'woolly' reports are celebrated as a good product in a sensitive environment of mass deception[32] through evaluation concerning foreign aid. Similar to aid reports, planning reports indicated very good results, but they had nothing to do with reality. Reports suggested that plans were implemented satisfactorily, while the economies were in ruins. Some members of interest groups (like party and state officials or managers) got rich, while citizens remained in poverty- nothing different than foreign aid.

There will be no solution to allocate a larger evaluation budget and try to produce relatively more accurate reports on projects since the structure of incentives will remain the same and the new product would be not much different from the current outputs. Even when a grosser misuse of aid is found, as a rule there need not be an appropriate reaction.

Despite all indications that aid fails, a dominant position in aid granting countries and aid agencies is that the aid is helpful to recipient countries. This conviction

[32] Aid agencies repeat the same promises over decades that better times will come soon and they never come. Easterly (2003, p. 35-36) has collected such anthological quotes from the World Bank reports related to Bank spending in Africa over more than twenty years: "From a 1981 World Bank report, *Accelerated Development in Sub-Saharan Africa* (p. 3): 'Policy action and foreign assistance … will surely work together to built a continent that shows real gains in both development and income in the near future'. From a 1984 World Bank report, *Toward Sustained Development in Sub-Saharan Africa* (p. 2): 'This optimism can be justified by recent experience in Africa … some countries are introducing policy and institutional reforms'. From a World Bank report, *Financing Growth with Adjustment in Sub-Saharan Africa* (p. 15): 'Progress is clearly under way. Especially in the past two years, more countries have started to act, and the changes they are making go deeper than before'. From a 1989 World Bank report, *Sub-Saharan Africa: From Crisis to Sustainable Growth* (p. 35): 'Since the mid-1980s Africa has seen important changes in policies and in economic performance'. From a 1994 World Bank report, *Adjustment in Africa* (p. 3): 'African countries have made great strides in improving policies and restoring growth'. From a World Bank report, *Can Africa Claim the 21st Century?*: 'Since the mid-1990s, there have been signs that better economic management has started to pay off'. From a 2002 World Bank press release on African Development Indicators: 'Africa's leaders … have recognized the need to improve their policies, spelled out in the New Partnership for African Development (NEPAD)."

is based on prejudices, wishful thinking or biased evaluation. Evidences show that foreign aid has no tangible impact on the long-term economic growth and improvement of conditions in target countries. This is in accord with a broader conviction that central planning that never ended poverty. The task of evaluation is to hide failure and damage by reporting some degree of success; therefore, the evaluation process is irreparable. Deliberately spreading delusions is damaging because it distorts perception and prevents proper action. Prospects for getting more accurate reports are murky and this is sometimes confessed even by official super-evaluators of the largest aid donors: "Pessimism prevails to the ability of evaluation to improve transparency and accountability towards taxpayers, or even to enhance aid program performance in general; evaluation itself is subject to political manipulation".[33] Changes external to aid delivery, like more intensive lobby group activities, public awareness campaigns and similar actions may slightly improve the aid performance evaluation, but they can not reshape the structure of incentives.

CAN FOREIGN AID BE SIGNIFICANTLY IMPROVED?

If foreign aid is highly ineffective, can its failure be recovered in order to get better results? Some modest improvement is possible. If reasonable politicians rather than senseless technocrats would be in charge of aid programs; if sensitive and educated aid workers would be recruited rather than ruthless, undereducated and biased individuals; if moral hazard, corruption and adverse selection would be reduced by closer monitoring; if more realistic reports would be produced through further investigations of this process; and if the evaluation agency would be co-responsible for the fate of the program- then foreign aid may be improved to some moderate degree. However, it can neither be effective nor comparable to private investment. The same may be said about central planning. Its failure may be moderated and postponed by implementing suggestions similar to those mentioned above. But that is utopian since it would require the change of human nature. In the present world, the largest hurdle to improve foreign aid or central

[33] Martens, 176.

planning is represented in the structure of incentives.[34] It is settled in such a way that aid cannot be reshaped to look similar to the operation of a profit firm, i.e. it prevents the introduction of more effective means for functioning, monitoring and evaluation. Due to its structure of incentives, foreign aid is ineffective because of its nature rather than because of some particular other mechanism. While being similar to central planning, foreign aid is irrecoverable. Central planning was always on the move, but never truly reformed. After its collapse in the Central and East Europe and elsewhere in the late 1980s, the system was abandoned and replaced with some type of market order.

Although this is the case, there are some optimists who would like to revolutionize foreign aid in order to make it efficient. One type of optimists relies on aid privatization, another on conditional aid.

Concerning privatization, let us ignore for now the fact that foreign aid is nationalized. Even if one assumes, for the sake of argument, that foreign aid is private, this will not significantly change the efficacy of aid. There will probably be some slight improvement along the chain of command, as it was suggested before, but the structure of incentives will remain the same. In the case of aid, the market cannot exercise pressure like in some commercial activity. In the best case, some competition may exist among private donors to help recipients in need, but privatization is not needed in order to see competition.[35] However, competition among donors does not necessarily improve the quality of aid delivery, since the demand for aid, due to its low cost, is endless rather than limited. It merely provides a good opportunity to diminish the responsibility of each aid agency operating in a country. The more aid agencies operating in a country, the more difficult it becomes to address the responsibility of any particular one among them. Aid failure becomes someone else's fault.

Another idea for aid privatization relies on the ability of private firms to develop aid programs as a part of their commercial programs. For example, in order to get a new market, a soap producer may launch an educational campaign on the risks

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[34] Easterly (2003, 2006) is inconsistent on the main point. On the one side he believes that aid is similar to central planning and that "the right plan is to have no plan". On the other side he believes that reform of aid is possible if grand plans are abandoned and replaced with careful social engineering on the small scale. He neglects that small scale planning is still planning. It seems that he is not able to get rid of planning and aid after serving 16 years in the WB aid projects.

[35] Competition may exist among different development donors operating in a recipient country.

posed by dirty hands. There were such examples on the Indian subcontinent and elsewhere. Such moves may be more successful compared to classical aid programs. However, potential fields for such programs are relatively rare, and this type of aid is just hardly separable from the usual commercial activity.

Another proposal to improve the efficiency of foreign aid is conditional delivery. Aid will resemble a kind of prize – countries conducting more reforms will get more aid, while countries resistant to reform will get no aid at all.[36] This proposal leaves the donor untouched and assumes that the improvement may result from a change in the recipient's motivation. This is the basic tenet of the U.S. project called *Millennium Challenge Account* (MCA), a new scheme of foreign aid to be introduced step-by-step during the forthcoming years. This proposal initially sounds better, but upon further consideration it shows no improvement. The MCA will not touch the structure of incentives on the donors' side, which is the main problem of aid as it exists now. It will ask for a change in recipients' attitudes, which is a minor problem now, and what will not bring about any significant improvements. Even now, foreign aid is a kind of prize, and the only difference to the proposal consists in the fact that it is now distributed unselectively. If the number of reformers among recipients up to now was low, there will be no profound change in their attitude in the future. The only important consequence of the MCA proposal will be that a significant number of recipients are going to be cut off from aid. Some rulers will intentionally prevent reforms in their countries in order to prevent inflow of aid that creates opportunities for foreign interference into domestic affairs. Despite being in dire need, some populations will not be eligible for foreign aid. Others may be eligible despite being in much better position. This will question the main official rationale of foreign aid. Instead of being distributed proportionally to the suffering and needy, it will become a subsidy to friendly and cooperative regimes.

This exclusion of non-cooperative regimes will happen only if other donors follow the U.S. case. With no change in the attitude among other donors, recipient countries will not be stricken to a degree that they will feel a difference.[37] The MCA will

[36] The measured indicators would be governance, economic liberties, democracy and women's rights, as they are estimated by the World Bank, Heritage Foundation and Freedom House.
[37] Cutting aid is far too week to accomplish some results, and the track record of on-again-off-again is miserable.

affect probably more the U.S. interests in a number of countries rather than inducing a change among potential recipients.

Analogous to the MCA, the UN has launched the program for Africa called the UN *Millennium Development Goals* (MDG). It is based on sharp increase of donors' contributions for 170% compared to now, i.e. on their rise to 0.7% of donors' GDPs. The MDG recommends eight umbrella goals, 54 indicators of poverty and 449 separate aid operations to be achieved in Africa by 2015. The MDG's main strategist is moderate when he states that the "… goal is to end extreme poverty, not to end all poverty".[38] This is another retreat in development philosophy, after it was denominated in 1980s from promoting development to alleviating poverty. It is not clear why the budget now should be larger if the general objective is reduced.

Similar to central planners, Sachs just declares good intentions and never asks how they are going to be achieved. He never poses the question what are the incentives for people to get things done. He just deals with administrative, technical and bureaucratic procedures of providing aid. It is puzzling how the MDG will inspire a change in foreign aid implementation if even its language more closely resembles the press releases of the Soviet committees rather than an inspiring tone inspiring spurring on change in the field. This is visible in the terminology used by its main author, Jeffrey Sachs:[39]

> "… a needs assessment is a key input to … a policy **plan**… The second stage of the **planning** process will be for each country to develop a long-term (10-12 year) **framework** for action for achieving the MDGs…This MDG **framework** should include a policy and public sector management **framework** to scale up public spending and services, as well as a … financing **strategy** to underpin the **plan**. The third stage of the **planning** process will be for each country to **construct** its median term (3-5 year) poverty reduction **strategy** (PRS) based on the long-term MDG **plan**. The PRS (poverty reduction **strategy**) is a move detailed, operational

[38] Sachs 2005, 289.
[39] Sachs 2005, 285.

document, and should be attached to a Medium Term Expenditure **Framework** (MTEF)".

Even the communist planners did not frequently use words like planning, framework or strategy as Sachs does. Following that habit, the handbook for the MDG uses the word *strategy* nine times in the text and six times in the figure, just as on the first page of its introduction. Based on recycled ideas that planners used for several decades, the MDG program may be considered miscarried before its birth, and even more harmful if it is born.

In conclusion, foreign aid is not just ineffective because it has the same structure of incentives like central planning. Instead of inspiring development and alleviating poverty, as it was repeatedly pointed out, foreign aid helps to preserve the poor state of affairs and entrenches power in those responsible for the poor conditions. It is also damaging for preserving poverty, strengthening the state and stimulating corruption. Proposals to change aid either via its privatization or by making it conditional stop short of changing the structure of incentives. Despite being ineffective, aid will probably continue to exist but be followed with less enthusiasm about its effectiveness. Instead of helping those in trouble, it erodes their position while serving some other interests.

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