

A REVIEW OF THE LEGITIMACY OF FOREIGN AID IN CONTRIBUTING TO ECONOMIC PROSPERITY

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Abstract *Foreign aid, the altruistic act of sovereign fund transfer, is thought to be a panacea for economic prosperity, along with a myriad of other socio-economic benefits, in developing and underdeveloped economies. The historical narrative of foreign aid as an indispensable tool for economic development is not without criticisms, as its contribution towards poverty alleviation, economic growth, and income inequality reduction is often questioned. In addition, intricate interactions of various factors - conditionality, institutional failure, and corruption - have made measurements of foreign aid effectiveness even more complex. Conditionality restricts aid effectiveness, while widespread corruption and institutional failure escalate the existing problem of income inequality. This seemingly insurmountable conduct has proven to be a daunting challenge, as developing countries struggle to unfasten themselves from the insidious grip of corruption and institutional failure, which is a painfully pervasive dispiriting reality. This study focuses on the historical narrative of the concept of foreign aid provision and attempts to present a synthesis of the contemporary literature on the numerous socio-economic variables that disorient foreign aid's efficacy.*

Keywords *Foreign Aid, Institutional Failure, Income Inequality, Conditionality, Corruption*

INTRODUCTION

The diametrical economic disparity of developed and developing countries has been the focal point of a plethora of academic fields and numerous international policies. A primary policy tool in bringing out economic betterment in destitute nations has been the use of foreign aid. The idea was that transfer of funds from richer to poorer nations would stimulate economic prosperity in developing and underdeveloped countries. However, does this concept hold any merit? Or is this just an example of altruism, lacking anything tangible? Over the decades, foreign aid has been studied in a multitude of policy and academic fields, without any overarching consensus. The term aid does not have a concrete definition (Bauer & Yamey, 1989). Generally understood, it is the voluntary transfer of resources from one sovereign nation to another, without necessarily any payback obligation, and it has primarily been directed towards the third-world. Although it may be an overgeneralisation to lump together all the third-world countries, which have wide differences in social and physical environments, attitudes and mode of conduct, and different objectives and government policies - they all share one common characteristic, foreign aid. The concept of the third-world and foreign aid are inseparable as 'Without foreign aid, there is no third world' (Bauer & Yamey, 1982, p. 55).

The origin of conventional sovereign foreign aid can be traced back to the Marshall plan implemented in Europe after the Second World War. It was highly effective in ensuring the recovery and reindustrialisation of Europe (De Long & Eichengreen, 1991; Eichengreen, 2001). Since then frequent attempts have been made to replicate this success story in numerous parts of the world. The most commonly used measure of foreign aid is the Official Development Assistance (ODA). The bulk of ODA comes from 23 developed countries and the European Union that chair the OECD's Development Assistance Committee (DAC) (Keeley, 2012).

For many underdeveloped countries, foreign aid constitutes a significant portion of their national income. Aid undoubtedly acts as a revenue provision for the government (Boone, 1996; Collier & Dollar, 2004). On the contrary, it makes up a relatively insignificant expenditure for the donor countries in comparison to their national income. This phenomenon, coupled with the fact that many poverty-stricken individuals in developing countries are subject to dire conditions, encourage many Non-Government Organisations (NGOs) and humanitarian agencies to opt for aid transfer even if it has conditionality attached to it. In addition, the advent of a globalised investment market has attracted a multitude of investors from the developing world to invest in

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predominantly developed countries in the form of foreign aid.

Citizens of well-off countries expect aid money to find its way to the poor and vulnerable, when in fact this goes to the elites of developing and under-developed countries. Unfortunately, the term aid has been monopolised by its advocates to claim compassion and dismiss critics as heartless (Bauer & Yamey, 1989). A poll conducted by WorldPublicOpinion (2010) found that the average United States citizen vastly overestimates the proportion of the US federal budget devoted to foreign aid. The survey found respondents believed it was about 27 per cent of the US federal budget, but in actuality, it is about 1 per cent. Thus, foreign aid goes beyond just development policy, as donor governments have to keep up a positive and philanthropic image in the minds of its citizens to win hearts and minds.

Critics of foreign aid frequently raise the issue of justice and morality. Foreign aid may be provided simply because the recipient country happens to be ideologically correct. This was predominantly evident during the Cold War when the Soviet Union and the United States competed, both for ideological dominance, and the heart and minds of developing countries. Moreover, Bauer (1976) argues that foreign aid is unjust and not necessarily moral, as the commonly used analogy between foreign aid and charity is not accurate. Any government's foreign aid is essentially taxpayers' money that is mandatory for the citizens of donor countries, who are often unaware of their contribution. Since it is not a voluntary transfer by most of these individuals, it cannot be termed fully just and completely moral. This is not to say that there is no dissenting view, as Chong and Gradstein (2008) point out, that the average voter in donor countries do have a level of leverage over tax provision since the majority of donor countries are exclusively democratic nations. Any transfer of aid that is unpopular among the people would be detrimental to the ruling party, thus testifying that aid from donor countries are, at least to some extent, voluntary and arguably just.

The fact that decades of foreign aid provision has not pushed developing countries into the desired developed zone made analysts question the foreign aid mantra. An interesting point that leads to much of the scepticism behind the motives of foreign aid stems from the fact that donor governments, who are under pressure at all times in using taxpayer money in the most efficient way, will likely not give away millions of dollar worth of aid simply because it is the right thing to do. This raises the eyebrow of many analysts and citizens of recipient countries who feel uneasy thinking that there could be sinister motives behind such aid provision. It is thus extremely important for all stakeholders from donor and recipient countries to know the pros and cons of foreign aid provision and keep track of the criticisms. This paper

thus investigates and reviews the literature on foreign aid's effectiveness in the presence of various socio-economic factors. In particular, the intricate interactions of various factors – conditionality, institutional failure, and corruption – with foreign aid and its effectiveness.

FOREIGN AID AND IMPOSITION OF CONDITIONALITY

In recent years, some economists have staunchly criticised the prevailing method of foreign aid provision and deemed it ineffective (Polak et al., 2007), while others argue that it is only effective under the right circumstances (Layton, 2008). Even if aid is not repayable monetary-wise, it is not uncommon to have conditions or strings attached to it. Stipulated conditionality often defeats the whole purpose of aid provision in the first place. The situation is sometimes made even worse when the objectives of donor governments are counterproductive to the development of aid receiving countries. Crawford (1997), in an attempt to lay out the effectiveness and consistency of foreign aid, found that restricted and conditional aid is ineffective in producing any improved political reform in aid receiving countries. This failure is explained more by the negativity of restrictions imposed than the strength or institutional quality of aid receiving governments.

Despite all criticisms, it is possible to allocate foreign aid explicitly designed to benefit the poor. Macdonald and Hoddinott (2004) take an unorthodox stance on conditionality and argue that aid is moderately altruistic, as stipulations of donor countries sometimes force the incorporation of humanitarian, commercial, and political considerations. Thus, the conditionality that aid agencies include in loans and grants can be designed to force governments to use aid in ways that benefit the poor. So, even if aid-receiving governments are inefficient or corrupt, the imposition of conditionality severely restricts the maneuverability of the government and, for the most part, improve transparency and keep corruption in check. Consequently, conditionality does not necessarily have to be bad if donor countries can wisely attach clauses that are designed to provide maximum effectiveness. Thus, in theory, the imposition of conditionality that is explicitly designed to help the economically vulnerable could, at least partially, solve the problem of foreign aid ineffectiveness, but this requires persistent commitment by the donor countries (Younas, 2008). Moreover, providing aid to sectors that have failed to show any signs of improvement should be seriously reconsidered. Donor countries must also take responsibility in carrying out their development cooperation programmes so that aid-receiving governments follow their binding obligations of upholding human and economic rights that are in line with internationally and universally agreed standards.

Although donor countries' decision behind aid selection and aid allocation looks straightforward, it is far more complicated than it appears. A number of reasons often lead to the decision of aid provision. These include attitude and friendliness between recipient and donor governments, institution and absorptive capacity, concerns over governance, and colonial and commercial interests (Sumner & Mallett, 2012). Foreign aid is mostly helpful under accommodating policies and good institutional quality (Khuhro et al., 2012). Clearly, not all decisions are in line with poverty or income inequality-reduction policies. Some appear to be geared towards quenching the thirst of self-interest entities more than anything else. For instance, many African countries that rank high in poverty levels do receive sufficient aid, but due to the lack of good practicing policies aid remains relatively ineffective. These instances clearly demonstrate weak and flawed government policies in terms of resource allocation.

FOREIGN AID AND CORRUPTION

The effectiveness of foreign aid is complicated because of the presence of corruption in most developing countries. It is, however, interesting to observe that corruption does not play a determining role in the quantity of aid that flows to recipient countries. This is evident from the fact that the countries frequently labelled as corrupt, receive no less aid money and there is hardly any statistical proof to argue otherwise (Alesina & Weder, 2002). These funds are sometimes embezzled and lavishly spent by the bourgeoisie that is closely tied with the officials in power (Drazen, 2004). An unfortunate epilogue of corruption is that many a time governments are inclined to favour bourgeoisie political elites (Boone, 1996). And as such, foreign aid allows the government officials to indulge further in corruption and misappropriation of funds. In some instances, aid is even used as political leverage and held hostage in the political arena, where it is bartered in exchange for demands or favours. Governments of aid-recipient countries also have incentives to engage in policies that diminish growth and worsen the income parity. Ineffective and corrupt governments have little incentive to alleviate the conditions of the poor, in fear of more political activism. In many cases, improving the conditions of the poorer masses results in people having more access to higher and better education. This may create more politically, economically, and socially aware citizens, which may turn out to be detrimental to corrupt elitist governments (Easterly, 2003). Therefore, government officials utilising their power to maximise private gains, and influence public policies to benefit a select few, are not aberrations, but rather a common phenomenon in developing countries. This kind of policy influence creates ample opportunities for corruption, which in turn intensifies income inequality and poverty in most developing countries. Gupta et al. (2002) and Wei (1997)

empirically presented the relationship between corruption and income inequality, as well as corruption and poverty, and strongly emphasise the distributional consequences of corruption and the loss of public sector expenditure due to funds being redirected. Such findings point towards the general belief among economists who say that the rich, influential, and well-connected individuals under a corrupt regime are the first to receive government-sanctioned funds and aids. The distributional inefficiencies are more likely to be worse the more corrupt a country is, and the more such corrupt entities intervene in fund allocation. Foreign aid thus encourages corrupt governments to refrain from improving the quality of institutions in the country in an attempt to drive the economy into a crisis, thereby securing more aid inflows. In addition, a rigid and ineffective institution makes it much easier to redirect aid money to a more favourable group of people, who are not necessarily poor or in poverty. Redirecting aid flows to benefit the influential elites not only wins them support and access to heavy funding, but also keeps a sizeable population below poverty. This creates the need and motivation for more inflow of aid, which the government can take full advantage of (Reuveny & Li, 2003). The exceptionally powerful high-income elites in developing countries keep the aid flow more and more concentrated, and enjoy income many times above the national average, which is completely antithetical to the objectives of foreign aid.

Further, it has been observed that the intentions and preferences of policymakers in aid-recipient countries may not always be in accordance with improving economic growth, poverty, or income inequality reduction. Aid that was meant purely for development purposes were many a time redirected to other political priorities, such as defense or national security (Addison & McGillivray, 2004). North Korea and Pakistan are notable examples, where foreign aid was added to their defense budget instead of the development budget, as originally intended. In addition, it is often the case that a well-intended policy may simply waste aid resources on projects that have very little productive value. It is universally accepted that low or no corruption provides the best outcomes. Chong et al. (2009) noted that when corruption is relatively low, an increase in foreign aid provision decreases income inequality, but has the opposite effect in the presence of high corruption rates.

FOREIGN AID AND INSTITUTIONAL FAILURE

Poor institutions, poor government, and toxic politics are the primary reasons behind the lack of resources or opportunity (Deaton, 2013). Nobel Prize laureate Angus Deaton, a famous critic of foreign aid, identified what he calls a 'central dilemma', which implies aid is unnecessary

when the conditions for development are present, and aid is not useful or counterproductive when conditions are hostile to development (Deaton, 2013, p. 258). There is, however, a consensus that low-income countries, with the assistance of foreign aid, can improve the quality of a country's institutional infrastructure as well as enhance opportunities for further economic activities. And one of the integral facets of a nation's institution is infrastructure. This literature, with regard to infrastructure, has mainly resulted from conceptual and technical developments associated with new growth theory and new economic geography (Raychaudhuri & De, 2016). Physical infrastructure in the form of paved roads, railways, and so on, is important in linking poor, rural, and other underdeveloped and peripheral regions with areas of core economic activity, thereby allowing access to additional productive opportunities. In this context, it is believed that physical infrastructure development can help improve the distribution of income, as the impact is expected to be larger in poorer areas than in richer ones (World Bank, 1994). Therefore, the returns of a good quality infrastructure are higher for low-income countries. In other words, the marginal benefit is much higher in such circumstances. For instance, building one single road that connects a very remote, and previously inaccessible, town or village, would have very high economic and commercial implications. Strong infrastructural links to the highly developing base open up doors to economic opportunities and a passage for trickle-down¹ in developing countries. This creates improved and increased channels through which aid money can flow.

The link between infrastructure and generic income is multiple and complex, because apart from affecting production and consumption directly, it creates many direct and indirect externalities, and involves large flows of expenditure, thereby creating additional employment opportunities (Ghosh & De, 2005). A rise in the quality of infrastructure constricts income disparity as it induces inclusive growth. Not only does it help in unifying the country economically, but it also brings with it added advantages of occupational mobility and the expansion of markets that were previously untapped.

The complexity of foreign aid effectiveness goes beyond poor quality infrastructure into other facets of institutions, such as poor administrative capability. Many developing countries have faced problems of natural calamities and unforeseen circumstances that decimated the productivity base of the country (McArthur & Sachs, 2001). The African

AIDS epidemic of the 1980s is a good example, where millions of dollars' worth of funds had to be redirected to address the more pressing and immediate issue, thus draining considerable money away from institutional investment.

Another major institutional factor that determines the fate of foreign aid effectiveness is democracy. The conventional belief is that democracy is the silver bullet that channels foreign aid to improve growth, poverty, and income inequality. This, however, may be too simplistic. Developing countries that are marred by instability and poor institutional framework may not always benefit from adopting democracy during its early stages (Senese, 1999). This implies that democracy may be ineffective without a country reaching a minimum level of maturity. Moreover, the advent of China in the global arena is strong proof that democracy is not a prerequisite for economic growth or poverty reduction. Despite not opening up to democracy, China boasts high economic growth and high poverty-reduction (Folke & Nielsen, 2006).

Preference for ethnic groups is another imposing problem when it comes to foreign aid distribution, since many aid-receiving countries do not have a fair distribution of political power. If the leadership of a country predominantly belongs to a particular ethnic group or race, they may favour selected groups over others. This makes political sense from a selfish point of view, as uplifting the economic conditions of such groups, who in most cases are the most sympathetic voter-base, proves extremely helpful for the leadership, both financially and economically (Layton & Fuller, 2008).

FOREIGN AID, POVERTY AND ECONOMIC GROWTH

The relationship between foreign aid and economic growth, as well as the link between aid and poverty, is well talked about in literature (Connors, 2012). Yet, a significant statistical relationship between aid and economic growth is hard to find (Rajan & Subramanian, 2008). A plausible reason could be the poor utilisation of public choice theory and the aforementioned poor economic institutional framework. Aid simply cannot buy growth, as incentives of aid agencies are, many a time, theoretically and empirically not sustainable (Easterly, 2003). Historically, foreign aid has been viewed as an important tool in combatting poverty, and the belief was that sustained economic growth would be the channel through which the issue of poverty would be addressed. The conventional wisdom is that aid reduces poverty by raising the average income in recipient countries (Alvi & Senbeta, 2014). Burnside and Dollar (2000) established a significant relationship between economic growth and foreign aid, but only under the pretext of good policy environment. Another

¹'Trickle-down' was a term coined by Will Rogers in 1932, in an attempt to explain how accumulated capital that is invested by entrepreneurs will ultimately flow throughout the lower-income demographics in the form of job creation and increased economic participation.

publication presented to the IMF Research Conference by Easterly (2000) showed that aid has a significant negative impact on poverty.

Bahmani-Oskooee and Oyolola (2009) mention how alleviation over the years have replaced economic growth with poverty as the primary goal of foreign aid. They refuted a vague understanding by many economists, who proposed that economic growth was enough to reduce poverty. This was criticised by the authors who drew a relationship between foreign aid and poverty, and rejected the notion that only economic growth spiraled its way into poverty reduction. The interest in poverty reduction was partly sparked by the United Nation's eight Millennium Development Goals (MDG), where one of the primary goals was to reduce poverty in half by the year 2015. The UN set forth a comprehensive plan in tackling poverty and urged continuous support from large organisations, such as the G8 countries, IMF, the African Development Bank (AFDB), and many others. The most important and critical policy tool to bring about this ambitious goal was through the provision of foreign aid. Ever since the notion was put forward, economists found new meaning to the definition of aid effectiveness and started measuring poverty reduction to justify and define foreign aid. Now that the deadline for the MDG is over, it has bought with it a symbolic end to 15 years of speculation and can boast a relatively good success rate when it comes to poverty reduction and aid budgets (Sumner & Mallett, 2012).

Sceptics and critics of foreign aid often point out that poor economic performance and unsatisfactory poverty-reduction experiences in major aid-receiving countries are evidences of ineffectiveness. Bauer (1976) argued that foreign aid is not a mandatory condition for economic betterment. Although the intention behind foreign aid is to alleviate the poorer economies from poverty, the ability and effectiveness of foreign aid in bringing about sustained economic growth have been challenged and debated over the years (Alvi & Senbeta, 2014). Historically, the world economic system was a closed one, and for the most part did not receive much, if any, resource transfer. Despite this limitation, the developed countries overcame their economic challenges. As many countries emerged out of poverty without foreign assistance, the concept of foreign aid as an indispensable tool for advancement is inconsistent with the history of economic development. Moyo (2009) argued that countries, which frequently receive foreign aid, may become dangerously dependent on handouts, which may prove counterproductive in the long run. In line with his argument, critics reiterated that aid is more of a short-term solution than a long-term one that fails to address sustainable solutions. The critics are thus sceptical of the notion that developing countries or LDCs cannot make much economic gain without handouts,

and therefore, refer to examples of South Asia, most notably Japan, and many Latin American countries.

FOREIGN AID AND INCOME INEQUALITY

Income inequality is considered a yardstick in evaluating the significance of aid. This adds a unique angle to the debate, as a large majority of nations have been experiencing rising income inequality over the decades (Gottschalk & Smeeding, 2000). Given the income structure of developing countries, the tendency of worsening income inequality may be a naturally occurring economic phenomenon. This is because even if aid were to be distributed equitably among income groups, it would still worsen income inequality, because money distributed to the poor will be in smaller denominations than their richer counterparts due to the sheer number of poor (Boone, 1996). Studies, such as those conducted by Polak et al. (2007), which tried to establish if foreign aid had an egalitarian effect on income inequality, did not find any clear influence. The lack of a statistical relationship between foreign aid and income inequality, even in the presence of a good institution, has some association with the possibilities of foreign aid not having a significant impact on economic growth (Chong et al., 2009).

Sometimes, such weak allocations or distributions are not only limited to foreign aid but also to public spending vital for growth and economic betterment. Reductions in such social services mostly hurt the poor and deprive them of any sort of economic empowerment. This worsens the already prevailing problem of income inequality and poverty in most developing countries. Rose-Ackerman and Palifka (2016) argue that the diminished productivity of the poor, who make up the bulk of blue-collar workers, encourages more capital-intensive investments over labour-intensive investments. So, even when countries under corrupt regimes experience some form of economic growth, it is severely restricted to the poor who see little improvement in their own conditions. There are compelling reasons why rising levels of inequality can slow down growth prospects, when distortions affect different income groups unequally. Among other things, high levels of inequality can have adverse consequences on social cohesion, economic and political stability, and limit future economic prosperity to a selected number of people. In addition, there is evidence pointing to the widening of income inequality due to the deterioration of the political atmosphere in a country (Layton & Fuller, 2008).

Proponents of foreign aid sometimes espouse that aid flow may be beneficial to an economy, even if it leads to income inequality due to money disproportionately flowing to the rich and influential. With more money in the hands

of wealthy individuals, it is likely to increase investment in the economy, since they are the most likely candidates to engage in business activities than the poor who are financially challenged. This improves economic growth and provides jobs. This trickle-down effect may prove extremely beneficial to the poor. Boone (1996) was one of the dissenters of this argument, saying that trickle-down does not have a significant effect, since most of the money is not invested in the domestic economy. Countries where aid money can be easily accessed by a few influential individuals are usually marred by episodes of political and economic instability. Due to such risks, these individuals invest elsewhere in a more stable investment market, even if the opportunity for profit may be greater in the domestic market.

CONCLUSION

Foreign aid holds heavy sway in development literature. Studies have focused on the economic growth, income inequality, and poverty of aid-receiving countries, in an attempt to delve into the effectiveness of aid. The methodological paradigm used to understand foreign aid is not without its problems, as it spirals into a vast field that is influenced by numerous variables and economic phenomenon. A predominant reason for aid provision is for the eradication of poverty, mitigation of widespread income inequality, and helping those at the bottom quintile of the population. However, it could be doing more harm than good. For a multitude of reasons, the simple use of economic growth to vouch for foreign aid has lost momentum over the years as the recent trend suggests that economists refrain from simply using overall economic growth as the benchmark for judging foreign aid effectiveness.

Foreign aid is subject to the imposition of conditionality, institutional bias and failure, widespread corruption, and economic ineffectiveness. A general understanding is that due to the problems of conditionality, aid mostly flows to political high-income elites, thereby worsening income disparity (Layton & Fuller, 2008). These elites and corrupt governments in developing nations enjoy the money that flows through foreign aid, and in many cases, the poor do not receive any of the benefits of aid. As previously iterated, in some countries, the aid money had been used by the government and policymakers for purposes other than poverty reduction and economic well-being. Inept governments may spend aid money in projects that do not add any value to the economy. The wastage of aid is due to poor execution of projects and programmes, and doubtful conditionality (Bourguignon & Sundberg, 2007). Therefore, fair distribution and effectiveness also depend on governments' and institutions' intentions and adeptness

in handling aid money. Due to the complexities of various socio-economic and political factors, the effectiveness of foreign aid has remained a debatable topic in development literature. Needless to say, it is our collective determination, reexamination, and prioritisation of the right hierarchy of values that will reorient foreign aid to tackle the insurmountable task of economic development in destitute nations.

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