

## Development and the Political Economy of Foreign Aid

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### Abstract

This essay critically reviews findings on the economic effects of foreign development aid and lending, and on the “high” and “low” politics of aid. Although aid appears not to increase growth, reduce corruption, or increase revenues in recipient countries, donor countries are unlikely to reform aid and lending programs because these programs successfully serve political purposes. Alternatives to publicly funded aid are considered.

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### I. Introduction

In a recent essay for the online magazine *Cato Unbound*, economist William Easterly (2006) described the failure of aid to the developing world in these terms:

This is the tragedy in which the West already spent \$2.3 trillion on foreign aid over the last 5 decades and still had not managed to get 12-cent medicines to children to prevent half of all malaria deaths. The West spent \$2.3 trillion and still had not managed to get \$4 bed nets to poor families. The West spent \$2.3 trillion and still had not managed to get \$3 to each new mother to prevent 5 million child deaths.

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According to Easterly (2001), the main problems with foreign aid have been: 1) an inappropriate development model based on the “financing gap,” and 2) maladministration, caused by a lack of accountability for aid agencies to the people whom they are supposed to serve. He then proposes to reform the way foreign aid is administered so that it actually benefits the people whom it is supposed to help. This paper goes beyond Easterly’s contingent critique of foreign aid to argue that aid agencies are essentially un-reformable. Easterly’s argument effectively treats the state as exogenous, assuming that political actors are trying to make aid programs work but failing simply out of ignorance. By contrast, this paper reviews research on the political economy of foreign aid and argues that both humanitarian aid and multilateral structural adjustment and development assistance through the International Monetary Fund (IMF) and World Bank have actually been designed to fail in their ostensible aims: if they were to be reformed along the lines Easterly suggests, they would lose their political *raison d’être*. While publicly funded development aid has largely failed in its stated objectives, there is substantial evidence supporting the benefits of private foreign direct investment (FDI) and microlending. Both historical and contemporary evidence suggests that the most important pro-development reform that Third World governments can make is to structure their political institutions so as to facilitate credible governmental commitments to private property rights, contract enforcement, and competitive markets.

The plan of the essay is as follows. The next section reviews the economic evidence demonstrating the general failure of foreign aid to promote long-term development. The third section reviews the political science research demonstrating that failing aid agencies are actually “succeeding” in their political aims, and that government officials therefore have little reason to support fundamental reform. The fourth section reviews what we do know about the determinants of long-run economic growth. The fifth section concludes with implications for both developed and less developed countries.

## **II. Foreign Aid and Economic Development**

Publicly funded foreign aid is offered in two forms: direct grants-in-aid and loans. Branko Milanovic (2006) argues that loans through the IMF and World Bank should not be considered “aid” since they have to be repaid, but this argument ignores the fact that these loans

are offered at interest rates substantially below market – otherwise, governments would have no reason to accept them, given the policy strings attached (known as “conditionality”). Grants-in-aid are largely conducted bilaterally, government-to-government, or through United Nations agencies. Grants typically address imminent humanitarian needs such as famine and disaster relief, public health, and housing. The IMF and World Bank, which are principally funded by the G-7 developed countries, theoretically have different functions – promoting international financial stability and economic development projects, respectively – but since the collapse of the Bretton-Woods international monetary system in 1973, the IMF has broadened its mandate to cover any kind of assistance for governments trying to reform their economies (what the IMF calls “structural adjustment”).

The evidence that foreign aid generally has not enhanced economic growth is well-known. In *The Elusive Quest for Growth*, Easterly shows that in the vast majority of countries, development aid has not increased investment share of gross domestic product (GDP), and growth in investment share of GDP has not caused subsequent increases in GDP per capita. In only one country (Israel) has development aid had the intended effects on growth. Defenders of aid, such as Jeffrey Sachs<sup>1</sup> and Steve Radelet (2006), point to specific successful projects in which aid was a component. However, it is impossible to draw any general conclusions from these experiences, for two main reasons: 1) in case studies, it is impossible to control for other factors that may have been responsible for the success of the project, rather than aid: the counterfactual – how would the project have fared without aid – is unavailable; 2) even when an aid-funded project meets its own targets, we do not observe the opportunity costs of the project, all the other worthy endeavors foregone because taxpayer resources went elsewhere. The minimum acceptable effect of foreign aid on growth and other desiderata is therefore greater than zero.

Up-to-date, peer-reviewed, global studies of the effects of foreign aid on growth usually find either no general relationship or even a slight negative relationship. One of the main problems with aid is that a number of developing country governments have diverted aid to the private bank accounts of government officials. For instance,

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<sup>1</sup> Sachs, Jeffrey. 2006. “Foreign aid skeptics are wrong,” *Los Angeles Times* editorial, May 7.

Alberto Alesina and Beatrice Weder (2002) find that more corrupt governments receive just as much foreign aid as less corrupt governments, that the United States government even gives more aid to more corrupt governments, and that the level of aid a country receives tends to increase corruption in the future. Peter Boone (1996) also finds that aid goes mostly toward wasteful public consumption, Jakob Svensson (2000) finds that aid actually inhibits beneficial policy reforms, and Karen Remmer (2004) finds that foreign aid not only increases government spending, but it also reduces revenues, presumably because aid-dependent governments feel less need to promote the kinds of economic growth that generate tax revenue. Craig Burnside and David Dollar (2000) find that aid has a slight positive effect on economic growth when the recipient country has good policies, but since the evidence suggests that aid undermines good policies, their finding does not have clear policy implications.

The evidence on the IMF is equally disheartening. James R. Vreeland (2003a) has corrected for the fact that market-friendly governments tend to be the ones who seek IMF loans (and therefore would grow faster than other governments without IMF loans); once this correction is performed, he finds that IMF programs actually reduce economic growth by one and a half percentage points for each year the country remains under an IMF agreement. Vreeland also finds that IMF programs redistribute income from labor to capital and therefore increase income inequality.

In summary, foreign aid usually causes more harm than good. Although there might be specific instances in which aid programs have worked, it would be a mistake to draw general inferences for policy from the exceptions rather than from the rule. Critics of foreign aid programs do not necessarily argue that every single aid program ever conceived has failed, but that, since aid usually fails, maintaining current aid programs or creating new ones is probably a bad idea.

### **III. The Political Economy of Foreign Aid**

If foreign aid programs have usually failed, why do they persist? Some critics of foreign aid programs, like Easterly, argue that such programs can be reformed to work better, while others, like Deepak Lal (2006), argue that foreign aid is fundamentally unreformable and should, apart from emergency humanitarian relief or perhaps targeted

military assistance, be scrapped. Political economy considerations tend to support Lal's view over Easterly's.

That political scientists and economists have resoundingly rejected the view that foreign aid promotes economic development seems to have had little effect on policymakers, who pay lip service to "good policies and institutions" but have done little to roll back funding. Peter T. Bauer (1959) criticized the effects of U.S. aid on Indian development five decades ago. It is implausible to imagine that political leaders in donor countries simply do not know that their policies have been counterproductive. It seems much more likely that donor governments have their own interests in mind when lending or granting funds to developing country governments.

Two types of political considerations tend to foster the continuation of aid, even when it has failed at its stated objectives of promoting development and reducing poverty. The first is lobbying by those domestic interest groups in developed countries that stand to gain from aid programs, what international relations scholars call "low politics." Frequently, donor governments will eschew cash aid and instead offer vouchers to governments in developing countries, with which those governments can buy products made by firms located in the donor government's country. According to UN Food and Agriculture Organization Director-General Jacques Diouf, "Most food aid is donated on condition that it be purchased and processed in, and shipped from, donor countries, even when adequate supplies are available in the region where it is needed."<sup>2</sup> The United States government, for instance, requires that all food aid be transported on U.S.-flagged ships. Additionally, food aid can sometimes harm those it is intended to help, as when UN food giveaways in Mogadishu, Somalia, in 1993 went chiefly to the warlords and harmed the destitute and persecuted Rahanweyn farmers, who then could not sell their own produce (De Waal, 1993).

The second type of political consideration involved in aid lies in the realm of international diplomacy ("high politics"). The generosity of the U.S. government toward Israel and Egypt provides an example of this sort of aid, intended to bring other governments around to supporting the U.S. government view on international security issues. That the U.S. government frequently supported anticommunist

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<sup>2</sup> Agence France Presse. 2007. "FAO urges 'political will' to reform food aid," January 24.

dictatorships in the Third World during the Cold War is well known. However, U.S. aid still seems to be motivated more by “state interest” than altruism in the post-Cold War period. Alesina and Weder’s finding that U.S. aid goes more often to more corrupt governments than less corrupt ones has already been mentioned (the authors do note that U.S. aid goes more often to democracies than dictatorships, however). It is implausible that in most cases the U.S. government is actually seeking to encourage corruption, but it is likely that the U.S. government uses other political criteria to distribute aid and is relatively unconcerned about the adverse effects for corruption and development.

Is there any evidence that the U.S. government funnels aid to countries that pursue U.S.-friendly foreign policies? Yes. The most interesting work in this area has been done by Strom C. Thacker (1999) on IMF lending. The IMF itself claims that it makes loan decisions strictly on neutral economic criteria; indeed, its charter forbids the use of political criteria in IMF lending decisions. However, Thacker finds that the IMF not only fails to use sound market criteria in lending decisions (countries that have previously defaulted on IMF loans are *more* likely to receive loans than countries that have never defaulted), but also loans more often to countries that move toward the U.S. position in UN General Assembly roll-call votes. This political influence on IMF decisions is even more pronounced in the post-1989 than the pre-1989 period. More recent and sophisticated work has supported the general thesis that countries friendly to the U.S. are more likely to receive both IMF and World Bank loans (Andersen, Hansen, and Markussen, 2006; Andersen, Harr, and Tarp, 2006). Detailed case studies have shown that U.S. pressure was responsible for lenient terms on IMF loans to Egypt and Russia (Momani, 2004).<sup>3</sup>

This evidence might seem to support the charges of radical critics of globalization that the IMF and World Bank are tools of U.S. imperialism in the Third World, mechanisms whereby the Treasury Department imposes economic policies favorable to Wall Street investors and multinational corporations on helpless Third World governments. The truth is considerably more complex. It turns out that governments in developing countries seek out IMF loans precisely because they want the conditions attached to them. By

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<sup>3</sup> See also *BBC News Online* (1999).

blaming the IMF for unpopular economic reforms, these governments can evade the voters' wrath while still implementing the reforms that they secretly want. Both statistical and case-study evidence supports the argument that reform-oriented governments seek out, and receive, IMF loans, even when they do not "need" the loans on strict economic criteria, whereas anti-reform governments do not sign IMF agreements with strict conditionality, even when they are presiding over severe financial crises (Vreeland, 2003b).

In summary, we should not focus the blame for the failure of foreign aid programs on governments of developing countries or on governments of developed countries alone. In fact, both sets of governments are responsible. Foreign aid has been a mutually enriching business for both donors and recipients; unfortunately, the impoverished populations of the developing world are the ones who suffer the most. Because foreign aid is politically profitable, despite its economic perversity, we should expect that it will continue. Reform proposals that remove political criteria from aid decisions are essentially dead on arrival, as there is little incentive for politicians to change a system from which they benefit. Abolishing the IMF and World Bank would probably on balance do some good, but if reform is unlikely due to entrenched interests, abolition is also unlikely, although the visibility and simplicity of a "clean sweep" might make abolition better able than arcane, technical reforms to appeal to a grassroots, popular coalition.

#### **IV. Institutions as the Key to Development**

If foreign aid is not the solution for global poverty, what is? Both statistical and case-study research has demonstrated conclusively that private foreign direct investment, conducted by multinational enterprises (MNEs), promotes growth and raises wages.<sup>4</sup> FDI inflows promote growth not just in the developing world, but in developed countries as well, supporting the notion that MNEs bring new ideas and technology, thereby generating increasing returns for the economy, rather than just the one-off gains from the logic of

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<sup>4</sup> For a small selection of the evidence, see Garrett (2000); Blomstrom, Lipsey, and Zejan (1994); Easterly, King, Levine, and Rebelo (1994); Bhagwati (2004); and Bair and Gereffi (2001).

comparative advantage.<sup>5</sup> Contemporary economic theory suggests that technological adoption is the key driver of long-term growth.<sup>6</sup>

Critics of globalization have argued that MNEs promote a “race to the bottom” in taxes and regulations as governments compete to attract their investment. However, there is essentially no evidence of an aggregate decline in taxes, spending, or regulation in those economies most open to international investment (Garrett, 1998). Some have suggested that investors actually like “big government” because it provides public goods, but a less sanguine interpretation is that MNEs might be able to extract rents for themselves, shifting the tax burden to labor and domestic capital but leaving the overall levels of taxes and spending unchanged. Nevertheless, it is clear that less developed countries do not need to offer multinationals “corporate welfare” in order to obtain productive investment. As Bhagwati (2004) notes, multinationals attracted by subsidies generally add little value. Studies of American states have shown that tax breaks and subsidies do not generate positive externalities and may not even make a difference in businesses’ location decisions (Sugg 2007).

What can governments in developing countries do, then, to attract FDI and to speed up technological change in domestic industry? The real question is, What should these governments *not* do? Government-led industrialization is a risky business, and it usually fails. As Easterly notes, governments can kill growth. He points to six specific policy errors: 1) high inflation, which can be combated through an independent central bank, dollarization, or a currency board;<sup>7</sup> 2) high black market premiums, which can be eliminated by removing exchange controls; 3) high budget deficits, which can be tackled with a strong finance minister or a constitutional requirement that all legislation increasing spending must be fully costed; 4) killing banks, which doesn’t happen if inflation is low, black market premiums are low, and interest rates are liberalized; 5) closing the economy, which can be averted by slashing tariffs and restrictions on investment; and 6) government disservice, which can be caused by foreign aid or natural resource dependence

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<sup>5</sup> See, for instance, Caves (1996) on the logic of the horizontally integrated MNE.

<sup>6</sup> Easterly (2001) has a good discussion of this issue.

<sup>7</sup> F.A. Hayek, George Selgin, Lawrence White, and others have also suggested free banking with privately issued, competing currencies, a system that would eliminate inflation because economic actors would divest themselves of weakening currencies in exchange for stable ones.

and can often be addressed through the creation of private, competitive markets (Easterly 2001, ch.11). Robert J. Barro (1997) finds that high government consumption also reduces growth rates. Cross-national studies of FDI inflows specifically have found similar results: countries that are open to trade and have low inflation, budget deficits, and corruption attract more FDI. Moreover, democratic countries attract more FDI than authoritarian ones, while IMF agreements cause a decline in FDI inflows (Jensen, 2003; Jensen, 2004).

Having the right policies is important for development, but what makes it more likely that a country will have the right policies in the first place? Presumably, growth-killing policies benefit the politicians who implement and maintain them; otherwise, they would not exist.

To answer this question, we need to turn to the study of political institutions. Institutions can constrain politicians and provide them the incentives to pursue growth-enhancing policies. Competitive elections generally place a constraint on the most ravenous, destructive kinds of rent-seeking, and Helen V. Milner and Keiko Kubota (2005) have found that among developing countries, democracies are more likely than authoritarian regimes, particularly military regimes and personalist dictatorships, to liberalize trade. Barro (1997) finds an “upside-down U-shaped” relationship between “level of democracy” and growth, and, echoing the concerns of classical liberals such as Lord Acton about universal suffrage, infers that overly inclusive political systems can be bogged down with redistributive interest-group politics.

The real issue is whether institutions constrain politicians so that there is a credible commitment to maintaining private property rights and free markets (North, 1990). Political systems that give market-friendly constituencies effective veto power over future policy proposals help to establish credibility, because entrepreneurs then believe that they can make long-term investments without much risk of future expropriation. Unconstrained dictators cannot make credible commitments because a dictator can always change his mind: ex ante promises not to expropriate ex post are not credible. Among democracies, those countries with federal systems with hard budget constraints (Qian and Weingast, 1997; Rodden, 2003), finance ministers with veto power over budget items (Hallerberg and Marier, 2004), and closed-list proportional representation with large district magnitudes (Persson and Tabellini, 2003) tend to see less rent-

seeking and “over-grazing of the economic commons.” Independent judiciaries with judicial review can also pose a roadblock to rights-violating legislation, although the U.S. Supreme Court has largely declined to exercise this role on economic legislation since the 1930s.

Countries dependent on publicly owned natural resources or foreign aid tend to suffer from dysfunctional government because such governments do not rely on productive investment for tax revenue (Remmer, 2004). Therefore, these governments pay little cost when politicians use the manufacturing, agricultural, and service sectors as sinecures for themselves and their cronies, setting up state-guaranteed monopolies and monopsonies (Bates, 1981). The productive sectors of the economy may suffer, but the resource revenues and aid funds keep flowing into the public coffers. In these countries, some sort of total collapse or revolutionary upheaval might be necessary to create the sort of institutions that could constrain future governments.

The burden of reform is not solely on developing country governments, nor is the blame for persistent global poverty solely theirs. Rather than providing publicly financed aid, governments of the developed countries should eliminate their own agricultural subsidies and tariffs, which have distorted world markets so much that many African countries actually import food from Europe! These policies also encourage unproductive and ecologically destructive land use in the northern hemisphere. The recent support of Oxfam and other humanitarian NGOs for liberalized trade between North and South is an encouraging sign. Unfortunately, the U.S. government has not been a leader in this area. In fact, U.S. recalcitrance on farm subsidies may have doomed the Doha Round negotiations in the World Trade Organization. Western governments also need to ease their demands on less developed countries to adopt strict, Western-style intellectual property laws. Intellectual property laws are a creature of the state, and while they can play a role in promoting creativity, they can also inhibit creativity and protect monopoly power. They need to be designed flexibly to match the pace of technical change in different markets and industries. If the West is serious about reducing global poverty, they need to follow up their rhetoric of freer markets with action.

## **V. Conclusion**

Foreign aid generally does not promote economic development, for three main reasons. First, governments in developing countries have become dependent on aid, diverting it to government consumption while reducing their efforts at market reforms that would boost productivity and tax revenue in the rest of the economy. Second, donor countries have tied foreign aid to domestic interest group objectives and to international power politics; they have little interest in holding recipient countries accountable for achieving anything productive with aid. Finally, the driver of long-term economic growth is not more dams and factories and schools, the objects of most development assistance, but adoption of new technologies, broadly understood to include new ideas about how to organize workforces and production processes. Foreign direct investment has been shown to increase economic growth and worker incomes, principally because it transfers technology from the home country to the host country, upgrading workers' skills and allowing the country to move from labor-intensive development to the knowledge-intensive phase (Gereffi, 1999). However, FDI attracted by subsidies or intended simply as a way of working around high tariff barriers does not have these beneficial effects: it is important that FDI be attracted by real market incentives.

Countries can attract FDI and promote homegrown investment by credibly assuring investors that their assets are secure. These assurances are credible when political institutions constrain government officials in such a way as to make expropriation unthinkable. Therefore, developing countries can put themselves on the road to development with fundamental institutional reforms of that character. Of course, institutions are not easily changed – that is precisely their virtue and the reason why they can generate credibility. There may only be brief moments when a country will have an opportunity to create new, functional institutions that cannot easily be reversed in the future.

Rather than doling out aid, countries in the West can alleviate global poverty by ending their hypocrisy on free trade and opening their own economies to imports from less developed countries. This particular solution is not at all unthinkable; it is quite possible that Western governments will ultimately face a crisis of conscience on this issue and give in. Unfortunately, the debate around the UN's Millennium Development Goals has centered chiefly around the

issues of debt forgiveness and massive new aid, actions that will probably have little positive effect.

Even if we grant to aid proponents that there have been some aid successes, the evidence shows that IMF structural adjustment loans, and foreign aid more generally, tend to cause more harm than good. If a policy is likely to fail, then it should be abandoned. Apart perhaps from emergency assistance and certain kinds of military aid, foreign aid should not be publicly funded. The political temptations to misuse aid – on the part of both donor and recipient countries – is strong enough to resist any real reform attempts. Foreign aid is not the primary solution to global poverty – few, if any, scholars would dispute that – and it is probably a hindrance to the real solutions.

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