Bougheas, Spiros; Dasgupta, Indraneel; Morrissey, Oliver

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The Authors
Spiros Bougheas, Senior Lecturer; Indraneel Dasgupta, Senior Lecturer and Oliver Morrissey, Professor of Development Economics in the School of Economics, University of Nottingham. Corresponding author:oliver.morrissey@nottingham.ac.uk.

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Abstract

Charitable giving has increasingly become 'tough love' - it has come to require recipients to undertake costly prior action. A common justification is that of greater efficiency: willingness to undertake costly actions signals greater productivity from transfers. However, there is a trade-off. Conditions impose a cost, since the activities required are by themselves welfare reducing for at least some of the beneficiaries. We present a simple model to demonstrate that, if the distribution of recipient types is unknown, recipient costs are indivisible and productivity unobservable, conditional charity, once instituted, may not yield information adequate to refute its efficiency claim. Consequently, donors who inefficiently provide conditional charity will not correct themselves. Donors who wrongly provide unconditional charity may however subsequently correct themselves. We thus offer grounds for scepticism regarding efficiency claims for conditional charity. Our analysis also provides reasons for encouraging donor multiplicity.

JEL Classification No. F35, F34, I38, O20

Keywords: Tough love, Conditional Charity, Unconditional Charity, Donor Conditionality.

Outline

1. INTRODUCTION

Over the last two decades, charitable transfers in many different forms have come to require recipients to undertake some donor-specified action as a precondition for receiving the transfer, i.e., charity is more likely to be conditional. This is a marked shift from the earlier practice of donations with few or no strings attached (unconditional charity). Transfer practices both among and within countries exhibit this shift. The IMF, the World Bank and the European Union have all come to attach various preconditions on aid and concessional lending to nations.[1] Within countries, restructuring of welfare and anti-poverty programs over the '80s and '90s has largely replaced unconditional transfers with transfers conditional on some prior action by the recipient.[2] This shift is noticeable even in private charity to the indigent.[3] In all these widely differing contexts, recipients are no longer simply given charity, but rather are required to undertake some donor-specified activity in order to qualify for the charity. We call this *tough love.*

Within the public discourse, the basic argument justifying this shift to tough love appears to be that the poor happen to be poor due to some internal inadequacy, which they are able but not willing to eliminate. Thus, the IMF and the World Bank, in their public pronouncements, typically argue that countries are in need of assistance because they have followed wrong

1 See Section 2, example 2, below and papers in Koeberle *et al* (2005). For example, under the HIPC initiative, highly indebted countries are now required to undertake a number of years of an IMF-approved macroeconomic stabilisation program before being granted debt relief. The World Bank has advocated selective lending, to countries implementing approved policies, rather than the more traditional conditional lending (where recipients merely commit to policies). Countries in the European Union have come to explicitly link bilateral aid to political parameters (good governance) or human rights.

2 See Section 2, example 1, below. Welfare recipients in rich countries are now often forced to accept a process of bureaucratic screening, compulsory counselling and 'self-help initiatives' such as mandatory participation in job search and skill acquisition programs. The increasingly common use of the term 'workfare' in policy circles reflects exactly this shift. Anti-poverty and welfare programs in developing countries have increasingly come to make cash or in-kind transfers conditional on parents sending their children to school.

3 See Section 2, example 3, below. NGOs such as the Grameen Bank in Bangladesh and SEWA in India, which provide concessional lending and other facilities, require inordinately time-consuming group activities of their, predominantly poor female, members. Members are also subjected to major behavioural restrictions. Religiously inclined charitable organisations often require individuals receiving their support to abjure alcohol, drugs and sexual promiscuity.

policies in the past, would continue to require assistance in the future unless they amend those policies, and are unlikely to do so if left to their own devices. The unemployed are supposed to be so because they have few skills, but are not expected to alter this characteristic on their own. Similarly, the argument that motivates school attendance conditionality appears to be that the poor are poor because they have little schooling, and are likely to remain in that state unless prodded by the state (in particular, because parents may not act in the best long-term interests of their children).[4]

Implicit in the public rhetoric justifying tough love are both paternalism and the suggestion of 'weakness of will' - donors valuing the recipient's future consumption more than the recipient herself. Neither fits very smoothly within standard economic analysis. Furthermore, if most poor agents do find it possible to satisfy donor conditions and thereby qualify for transfers, then donor budgets would need to be adequately large. This sits uneasily with tightness in donor budgets frequently observed to be associated with tough love rhetoric. Perhaps for these reasons, in the economic discourse, the justification for tough love is usually formulated in instrumental terms, as an efficient response to an adverse selection problem. Some poor agents are intrinsically less productive than others. Recipient productivity is private knowledge, therefore donors use observable preconditions to impose costs on less productive claimants, costs large enough to drive them away. As budgets are constrained, givers aim to target charity to

those who will gain the most from it. This has given rise to a literature on the effectiveness of targeting in reaching the target population and only that population (see Cornia and Stewart, 1995), but our focus is on using conditions (prior actions) as a means of targeting. In this sense, tough love conditions perform essentially the same function as bureaucratic red tape.[5] Tough love is however rhetorically different from bureaucratic red tape: both require the prior

4 Thus, poverty *per se* is deemed insufficient justification for rights to resources. The idea was quite popular in the 19th century as well. Writing in 1906, George Bernard Shaw lampooned it thus. 'If a man is indolent, let him be poor. If he is drunken, let him be poor. If he is not a gentleman, let him be poor. If he is addicted to the fine arts or to pure science instead of to trade and finance, let him be poor. If he chooses to spend his urban eighteen shillings a week…on his beer and his family instead of saving it up for his old age, let him be poor. Let nothing be done for 'the undeserving': let him be poor.' (Shaw, 1975, p.17).

undertaking of some activity to qualify for valuable transfers, but bureaucrats typically do not claim that red tape is intrinsically beneficial for recipients.

We aim to highlight a basic problem with this targeting justification for tough love. This is simply that tough love has an inherent tendency to self-perpetuate. In many policy contexts, it may not be possible to validate the appropriateness of tough love unless donors who believe otherwise are also allowed to operate with very similar indigent populations. Yet such controlled comparisons are uncommon in practice. This is so because (i) donors such as the IMF, the World Bank, governments or large NGOs operate in markets with little or no competition (or where on donor is 'dominant' in the policy sphere), and (ii) when donors do face competition, their indigent populations are unlikely to be identical. Consequently, many existing tough love policies may in fact be persistent yet inefficient. Unconditional charity is more open to self-correction when inappropriate.

The case for unconditional charity stems partly from the claim that the poor happen to be poor because of factors they cannot alter.[6] Thus, for example, governments demanding debt relief often blame protectionism or high interest rates in rich countries for their plight, while poor parents cite teacher truancy as the reason for their refusal to send children to school. This claim implies tough love is wasteful, for two reasons. First, like red tape, it imposes costly actions on recipients. These impose a net loss because they do not address the underlying cause of poverty. Second, if some poor agents are significantly less productive than others, then this is largely due to *identifiable* structural factors that are independent of their activities. Consequently, the targeting gains tough love achieves can also be attained, perhaps even improved,

through proper use of non-activity information. In policy contexts, the contrast of tough love targeting is *indicator* targeting, where transfers are made conditional on observed non-income characteristics of the recipient population which recipients are assumed to find impossible (or

5 For discussions of red tape, see Banerjee (1997), Saha (2001) and Guriev (2004).

6 Other arguments being: (a) poverty, *per se*, confers a moral right to resources, and (b) poverty imposes costs on the non-poor. These arguments are not germane to our analysis.

at least very costly) to change, such as age, gender, race, religion, location, etc., instead of those they are likely to be easily able to alter (Dasgupta and Kanbur, 2005).

Our focus is primarily on the first issue, that targeting imposes (unnecessary) costs on (some) recipients. To fix ideas, suppose therefore some poor agents are significantly less productive than others, and this is due to factors they cannot alter, but that the donor cannot identify those factors. Suppose further that the donor can make transfers conditional on prior actions that impose net costs on less productive agents, so that such agents would refuse to accept tough love charity. Thus, tough love charity would transfer donor resources exclusively to more productive agents, whereas some such agents would lose out to less productive ones under unconditional charity. Evidently, then, whether one advocates conditional or unconditional charity would depend on answers to two empirical questions. First, what is the proportion of *more productive* agents for whom tough love conditions, by themselves, imply significant costs? Second, what is the proportion of agents who are irredeemably less productive? If one believes the first proportion is low (i.e., conditions are at least largely harmless for the more productive, and may beneficial), and/or the second is high (i.e., potential screening gains are large), one would advocate conditional charity. Opposing policy stances are thus generated by differences in beliefs regarding the distribution of agent types in the indigent population.

In standard adverse selection models, the proportions of agent types are common knowledge. In reality, however, donors typically don't have exact knowledge of the distribution of recipient types. They have to act on the basis of their beliefs (or priors). Their initial beliefs lead them to prefer conditional transfers to unconditional ones, or vice versa. But wouldn't the subsequent equilibrium reveal additional information that would provide grounds for rational tough love donors to alter their beliefs, if wrong? Wouldn't donors *learn* that they have made a mistake?

It is well known in other contexts that objectively wrong beliefs may nevertheless be self-sustaining: actions on the basis of such beliefs may lead to equilibrium outcomes which would

not provide grounds for learning, i.e., revising the initial beliefs.[7] This paper suggests this may hold for conditional charity as well. We show that, under weak and plausible restrictions on the donor's prior distribution of recipient types, when individual outputs are unobservable and recipient costs are sufficiently indivisible, the equilibrium would provide tough love donors no grounds for revising their beliefs. No learning can thus happen. More than one recipient type may find it optimal to pool (to behave identically), making it impossible to observationally distinguish between them. Consequently, initial beliefs may become self-sustaining, even when objectively wrong. The objective distribution of types would be revealed only if identical populations were offered both conditional and unconditional charity. No individual tough love donor would however have any incentive to engage in such experiments, for reasons already discussed. Thus, conditional aid policies by monopoly institutions, such as the IMF, the World Bank or national governments, are likely to exhibit persistence even when inefficient. Different donors, with different prior beliefs, may choose different policies. However, behavioural responses by the indigent are then likely to lead to different populations for different donors, thereby again making it impossible to acquire the information necessary to justify aid policy.

Our argument is however not a story of contrary beliefs being equally self-sustaining. We further show that, unlike tough love, unconditional charity may reveal information that would lead to its reversal. Thus, within the class of beliefs we identify, donors who wrongly provide unconditional charity may subsequently correct themselves, but donors who wrongly provide conditional charity will not. If output is observable, unconditional charity would reveal the true distribution of types, and thereby the efficient policy, but not charity with strings. This is quite independent of any screening gains unconditional charity may be able to achieve by using relevant non-activity information.

7 Examples include the canonical multi-armed bandit problem (Rothschild, 1974), price-setting by a monopolist facing an unknown demand curve (Nyarko, 1991), labour market discrimination (Coate and Loury, 1993), and political support for wasteful subsidies (Basu, 1992).

In Section 2 we discuss some detailed examples of the problem we have in mind, to ground our formal model in Section 3. Sections 4-5 discuss the main implications of our results. Section 6 discusses the situation with multiple donors. Section 7 concludes.

2. CONTEXT: TOUGH LOVE IN PRACTICE

We now proceed to discuss some examples of tough love, which, despite their widely differing contexts, share the basic features that we intend to isolate and explore in our formal analysis.

Example 1: Activity-based government transfers to poor individuals.

In many countries, state transfers to poor individuals have been made conditional on prior activities, typically involving children. Das *et al*. (2004) review 16 studies evaluating conditional cash transfers, ranging from Bolsa Escola in Brazil (paying parents to send children to school) to PROGRESA in Mexico (providing pre-school nutrition). The evidence suggests that the indigent are more likely to carry out activities dictated by donors when transfers are conditional. This implies such activities directly impose significant costs on at least some beneficiaries, otherwise the incentive schemes would have made no difference.[8] Obviously, for beneficiaries, the transfers outweigh these costs. However, it is by no means clear that even long-term returns to the poor from such activities, net of transfers, necessarily outweigh the costs. Thus, net returns fom these activities themselves may be negative, even when calculations are made over an extended time horizon. For example, poor parents may decide not to send children to school due to credit constraints even if net returns to schooling are high. However, the decision may also reflect the fact that net returns to schooling are negative, say because of bad school quality, inappropriate education or unemployment among the educated. Assuming the goal of the intervention is to increase household incomes of poor families, paying parents to send children to school would be efficient in the first case, but unconditional transfers may be appropriate in the second. Yet, since all recipients of conditional charity will

8 Furthermore, eligible individuals with high costs choose not to access benefits. These individuals however sometimes happen to be the poorest. This problem has received much attention in the literature (Das *et al*., 2004), along with the costs of bureaucratic monitoring. Our focus, in contrast, is on costs suffered by beneficiaries.

carry out the required actions, it may be impossible to infer from their observed behaviour which case is more prevalent.

Example 2: Policy-based multilateral aid or concessional lending to poor countries.

Traditionally, IMF lending was conditional on specified (macroeconomic) policy reforms being implemented. Although the reforms did not have to be fully implemented prior to funds being released, the practice was to release funds in stages as conditions were met. In principle, this would allow the IMF to identify countries undertaking the required actions, and to target resources on those countries. The implication was that IMF programs would be short-term, as recipients implemented the policies their economies would be stabilized, and this would eliminate the need for IMF support. However, this has not happened. Over time, short-term lending has given way to longer-term programs with more stringent and intrusive conditions. In effect, programs are rolled-over and thus amount to continuous financing. This, and the apparent failure of many interventions, has led to the emergence of prolonged users defined as countries under IMF arrangements for at least seven years out of any ten. Some 44 countries, covering all regions and levels of income, met this definition during 1971-2000 (IEO, 2002). Furthermore, frequent borrowers do not display evident improvements in their macroeconomic performance (see Bird, 1995 and Easterly, 2005). Indeed, otherwise they would not be prolonged users.

The macroeconomic policies the IMF sought to change may have contributed to the difficulties faced by some borrowers but were, at best, peripheral to those faced by others (Stiglitz, 2002). Furthermore, despite major failures, and despite much strident criticism, the IMF appears not to have significantly changed its beliefs about the relative proportions of these two types.[9] Federico (2004) argues that conditional lending has greater efficiency than

[9] Of course, the issue is complicated by many other factors. The Fund does not adhere strictly to its own selectivity – it faces other pressures to lend to particular countries. The major stakeholders in the IMF, especially the US, have strategic interests for ensuring continued lending to certain countries (IEO, 2002). This may help to explain why certain countries receive new or continued lending despite previous poor performance. There are other plausible explanations for why some countries become 'frequent borrowers'. Vaubel (1996) emphasises the bureaucratic incentive argument that IMF officials enhance their own power and prestige by sustaining programs. On the other hand, Willett (2002) argues that continued engagement maintains the link between IMF and government officials, and this should enhance the ability of the Fund to identify 'good' recipient types.

unconditional lending, in the sense that it allows better targeting of resources to more productive countries, but suggests that the gains in selectivity may be quite limited. It follows that conditional lending would be justified only if a large proportion of productive borrowers actually derived a significant net benefit from adjustment, at least in the long run, in addition to their direct benefits from Fund's financial support *per se*. This however is by no means self-evident. It is also plausible that at least some of the targeting gains could be retained under transfers conditional on country indicators that are independent of government policy, e.g. geography, disease prevalence, ethnic fragmentation or vulnerability to shocks on export earnings.[10]

Example 3: Behaviour-based non-governmental aid or concessional lending to poor individuals.

The Grameen Bank of Bangladesh, a highly successful, much-studied and much-copied non-governmental organization that provides cheap credit and other facilities to its (mostly poor female) members, requires that its members spend inordinate amounts of time in 'consciousness raising' activities. Members are expected to fulfil educational, hygienic, environmental and social obligations.[11] A potential member must first undergo observation and training including seven days of continuous instruction. She must participate in all training programs prior to being given a loan. Borrowers must attend weekly meetings held in the presence of bank staff during the period the loan is being used. They must be physically present at the meetings to repay their own instalments. Additional special meetings are often called to discuss group matters. 'Motivational' meetings are also arranged when members of groups face difficulties in making their loan payments.

Why does Grameen follow these seemingly unnecessary stringent rules, which impose large costs on its poor borrowers, but need not necessarily have a direct bearing on their

10 This indicators are typically poor discriminators; Anderson and Morrissey (2005) show that few countries exhibit consistently poor performance (on economic growth or infant mortality) over long periods of time, and that cases of poor performance are not robustly associated with structural characteristics, governance or policy indicators.

11 See *http://www.grameen-info.org/bank*.

productivity? Ameen (2004) finds that an increase in the opportunity cost of a borrower's time has a negative effect on loan repayment. He suggests that the repayment success of the bank is partly due to its time-intensive procedures that screen out those with high opportunity costs.[12] But are the consequent gains large enough to justify the costs imposed on borrowers, both directly, and indirectly through greater administrative costs? The answer clearly depends both on the proportion of defaulters under an unconditional lending regime, and of non-defaulters who actually achieve net income gains over time through 'consciousness raising' participation in training programs, group discussions and motivational meetings. Without information about these proportions, one cannot conclude that Grameen's strategy of conditional lending is superior to one of lending without such behavioural conditions. Indeed, the Badan Kredit Kecamatan (BKK) in Indonesia follows the Grameen in lending mostly to poor rural women, but does not require any kind of group involvement. Thus, one can think of the BKK as following the Grameen in indicator targeting (focusing on gender and location characteristics), but not in activity targeting (not requiring prior action). Yet, the BKK's repayment rates are not that much lower (Yaron, 1992). This suggests gains from better targeting achieved by Grameen's tough love practices *per se* (as distinct from those achieved by its indicator targeting rules) need not necessarily be very significant. It follows that Grameen's stringent behaviour-based conditions need not be optimal if most of its poor members are poor for reasons that have little to do with their behaviour or lifestyle.

3. THE MODEL

We now develop a model that captures the basic features of our problem. Consider an economy with $N \geq 3$ destitute (D) agents, who live for one period and face a potential donor. D agents can be of three types: strongly productive (s), weakly productive (w) and unproductive (u).[13] At the beginning of the period, all D agents face an indivisible investment

12 The Amanah Ikhtiar Malaysia, a replication of the Grameen Bank, made exceptions to these rules in the early stages of their credit program, but ran into difficulties with repayment. See Gibbons and Kasim (1990).

13 The generalization to more than three types is straightforward but does not yield any additional insight. Note that D can be interpreted as the (sub-)set of agents for which donors do not know the type – there may be other agents about which donors are certain.

opportunity that costs e. If w agents undertake an indivisible 'adjustment' action, at cost $\bar{c} > 0$, then they can increase the returns from their investment. Specifically, if w agents invest e and adjust at the level c, then they receive $(X - a + g(c))$ where $c \in \{0, \bar{c}\}$, $g(0) = 0$, $g(\bar{c}) = a, a > \bar{c}$. Types s and u receive X and 0, respectively, if they invest, regardless of whether they undertake adjustment or not.[14] Investment yields a surplus for productive agents, even allowing for the adjustment cost, i.e., $[X - e - \bar{c} > 0]$. Returns from investment and adjustment costs are simultaneously realized at the end of the period. Adjustment action has to be performed at the beginning of the period, *prior* to investment.

Intuitively, the parameter a measures the inefficiency of w relative to s agents. This inefficiency is due to factors (e.g. wrong economic policies, illiteracy, or lack of self-discipline) internal to w agents. Adjustment action eliminates these internal factors. The variable c represents both the extent and the cost of adjustment activity: $c = 0$ represents a choice by the agent not to undertake the adjustment action, while $c = \bar{c}$ represents the decision to do so at the appropriate level. With adjustment, investments by w types yield the same output as those by the s types. As $(a - \bar{c}) > 0$, there is a net gain to w agents from adjustment. The productivity of s and u agents is however determined by factors external to them - internal changes are costly, but irrelevant to their output. Their optimal adjustment level is thus zero.

There are various ways of interpreting our formulation of costs from adjustment. In the context of transfers to unemployed individuals, one thinks of these as the monetary equivalent of non-pecuniary welfare costs of time spent in mandated activities such as interaction with bureaucrats, participation in counselling, job search and skill acquisition programs and in group discussions, etc. In the context of policy changes imposed on poor countries, the costs are the long-term adverse, possibly pecuniary, implications. In the context of school attendance conditionality, one can think of possible future income losses from forgone labour market experience. The indivisibility in adjustment activities that we assume may be intuitively justified

14 For simplicity: we only need u agents to receive less than the other two types, say $\underline{X}$ if they invest, irrespective of adjustment. For this general case, we need to assume $[X - \max\{e, \underline{X}\} - \bar{c} > 0]$, while A1 below will have to be strengthened to:

both by provision and verification considerations. Individuals' activities in real life are often marked by indivisibilities in time allocation. Government actions involving privatisation, withdrawal of capital controls, political pluralism, religious freedom etc. are typically lumpy as well. On the other hand, donors' ability to measure adjustment is frequently imperfect, due to high verification costs and environmental shocks (actions may not result in the expected outcome due to exogenous events beyond the control of the agents). In practice, donor bureaucracies typically follow rules of thumb and broad approximation practices in measuring adjustment efforts.

N, *X*, and *e* are common knowledge, as is the function $g(\bullet)$, but individual outputs and investment are unobservable. Adjustment is observable. Every *D* agent's own wealth is zero, they have no access to credit, hence their ability to pay is zero – the price mechanism cannot be used to allocate resources to them. The donor lives for multiple periods. In each period, the pool of *D* agents is renewed, with the same distribution of types.

Each *D* agent's type is private knowledge. For any $k \in \{s, w, u\}$ the true proportion of *k* agents in the pool of *D* agents, assumed constant over time, is p_k. The donor knows $p_u > 0$, and also knows some upper bound for p_u, i.e., has a prior of some $l \in (0,1)$ such that $p_u \leq l$. This also implies she knows some lower bound for the productive types, i.e., $(p_s + p_w) \in [1-l, 1)$. However, she does not know the actual proportions. She has prior beliefs about these proportions, given by a subjective distribution function $F(q, p_u)$, where $q \equiv \frac{p_s}{p_u}$.

In each period, the donor has a total budget of:

$$B = kNe, \text{ where } 0 < k = d(1-p_u) < 1-l. \qquad (1)$$

$[\bar{c} > \max\{e, \underline{X}\}]$. Allowing an income differential between *s* and *w* types despite adjustment complicates the argument without adding any insights.

As the donor knows $p_u \leq l$, she knows $d \in (0,1)$, though she does not know its exact value. Thus, the donor knows her budget is not large enough to cover all productive agents.[15] Note that the donor would not know this without knowing some upper bound for p_u.

The donor's objective is to distribute her budget among D agents, so as to maximize their expected total consumption. Thus, we think of the donor as motivated solely by efficiency concerns, or more formally, as wishing to minimize expected recipient poverty according to the income gap criterion. If the donor chooses a D agent as eligible for receiving charity, that chosen agent must then adjust if required by the donor; this D agent will subsequently receive e. Eligible agents are free to adjust voluntarily if the donor doesn't require them to do so. D agents decide whether to apply for eligibility, knowing whether the donor will require adjustment if chosen. If the pool of applicants is larger than kN, given (1), kN agents are randomly chosen as eligible from the pool. We thus assume a *winner-pay* mechanism, where adjustment is not carried out unless one is guaranteed a subsequent transfer.[16] The donor's problem then is to choose the conditionality floor, i.e., the minimum level of c that chosen applicants must satisfy, so as to maximize the expected total consumption of the D population. Thus, the donor has to choose between a grant conditional on adjustment $(c = \bar{c})$, and an unconditional transfer (where eligible recipients may pick any $c \in \{0, \bar{c}\}$ without affecting the subsequent transfer).

We assume that adjustment is costly relative to investment.

A1. $\bar{c} > e$.

Suppose the donor offers a grant e, provided the recipient carries out adjustment first. By A1, all u agents will reject such a conditional grant. However, since $(a > \bar{c})$ and $(X - \bar{c} > e)$, all s and w agents would be willing to implement the adjustment, accept the grant, and use it to invest. By investing the grant, their return is $[X - \bar{c}]$. Since $d < 1$, not all applicants can be

15 This simplifies the exposition, but we only need the budget to be insufficient to cover all D agents, i.e., $k < 1$.

16 For convenience of exposition: our basic conclusions would not change if we assumed instead that some agents do not receive a grant despite adjusting.

funded. Assuming that available funds are allocated randomly among applicants, average consumption therefore is:

$$G_C = d(1-p_u)(X-\bar{c}). \quad (2)$$

Thus, conditional grants succeed in screening unproductive applicants out of the application process, and thus eliminate 'leakage'. This efficiency in targeting however comes at the cost of unnecessary adjustment, which leads to a total wastage of $dp_s\bar{c}N$ (as *s* agents do not need to bear the cost).[17]

Suppose now that *e* is distributed unconditionally. All *D* agents will then wish to apply. Thus, the equilibrium involves pooling. Consequently, given the donor's budget constraint (1), only $d(1-p_u)$ proportion of each type will receive the grant. Noting that *s* and *u* recipients will choose not to adjust, but *w* recipients will voluntarily do so, average consumption is:

$$G_R = d(1-p_u)[(1-p_u)(X-\bar{c})+\bar{c}p_s+ep_u]. \quad (3)$$

Thus, unconditional grants divert resources away from some productive borrowers. However, they eliminate waste from unnecessary adjustment. Note now that (2)-(3) yield:

$$G_R - G_C = dp_u(1-p_u)[q\bar{c}-(X-e-\bar{c})], \quad (4)$$

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17 George Bernard Shaw captured this equilibrium well in his portrayal of a Victorian Salvation Army soup kitchen, where charity is conditional on confessing one's sins and proclaiming spiritual conversion.

'PRICE. …Oh Rummy, Rummy! Respectable married woman, Rummy, gittin rescued by the Salvation Army by pretendin to be a bad un. Same old game!

RUMMY. What am I to do? I cant starve. Them Salvation lasses is dear good girls; but the better you are, the worse they likes to think you were before they rescued you.' (Shaw, 1975, p. 77)

He analysed the mechanism thus: 'When you advertize a converted burglar or reclaimed drunkard as one of the attractions at an experience meeting, your burglar can hardly have been too burglarious or your drunkard too drunken….(Y)ou will have your Snobbies claiming to have beaten their mothers when they were as a matter of prosaic fact habitually beaten by them, and your Rummies of the tamest respectability pretending to a past of reckless and dazzling vice' (Shaw, 1975, p.32).

where $q = \frac{p_s}{p_u}$ as defined earlier. Since $d > 0, 0 < p_u < 1$, (4) yields the following.

Lemma 1. *Given A1, there exists* $\hat{q}$ *such that unconditional grants generate greater total global consumption than conditional grants iff* $q > \hat{q}$, *where* $0 < \hat{q} = \frac{X - e - \bar{c}}{\bar{c}}$.

Recall now that the donor has to determine her transfer policy on the basis of her prior beliefs, i.e., on the basis of her subjective distribution function $F(q, p_u)$. Thus, she has to calculate her expected value of $(G_R - G_C)$ according to $F(q, p_u)$ (note (4)). A priori, there appears to be no compelling reason why the donor should not believe the distribution of q to be independent of p_u.

A2. For all $p_u^1, p_u^2 \in (0, 1]$, $F(q \mid p_u = p_u^1) = F(q \mid p_u = p_u^2)$.

Intuitively, A2 implies that the donor assumes there are underlying stable structural mechanisms or processes which strongly correlate the proportions of *s* and *u* types. For example, the donor may believe that the underlying distribution is skewed or normal. To see how natural such reasoning might be, consider the following example. Suppose a donor wishes to transfer resources to poor rural women, and makes such transfer conditional on their undertaking instruction in handicraft production and marketing (not unusual in rural credit institutions). Type *s* women are those who are capable of sustained manual labour, but have no aptitude for handicrafts or marketing. For these women, training in handicraft (the prior action) imposes a net cost, but they can increase their employment opportunities, and thus their earnings, by investing in a bicycle. Type *u* women also have no aptitude for handicrafts or marketing, but have some capability, albeit possibly with little inclination, for sustained manual labour. Type *w* women are physically quite incapable of sustained manual labour, say due to disability or long-term malnourishment, but have a natural aptitude for handicrafts. They can increase their returns from investing in modern tools for handicraft production significantly if they are also trained in the use of these new tools, and provided marketing advice. Suppose now there are few *u* women in the pool of destitute women in an area. Why might this be so? It appears

reasonable to attribute this to high demand for manual labour, say in agriculture, construction or public works. Then this high demand should also lead to very few *s* women, who are best endowed with the ability in demand, being destitute. Conversely, if a large proportion of destitute women happen to be type *s*, one would expect earning opportunities for manual labourers to be low. Then one would expect the pool of destitute women to contain a large proportion of *u* women as well. This reasoning leads one naturally to the idea that the distribution of $\frac{p_s}{p_u}$ might be largely independent of p_u.

Formally, A2 implies the support of F must be some subset of $\left[0, \frac{1-l}{l}\right]$. Such distributions must exist: for example, q may take the values 0 or $\frac{1-l}{l}$ with equal probability. By A2,

$$E(q, p_u) = q_E \in \left[0, \frac{1-l}{l}\right]. \qquad (5)$$

Note that A2 does not impose any restriction on the shape of the prior distribution function for q, apart from the two already mentioned, i.e. (a) it must be invariant with respect to the proportion of *u* agents, and (hence) (b) it must have some subset of $\left[0, \frac{1-l}{l}\right]$ as its support. Our subsequent discussion thus is compatible with distributions of any shape whatsoever, provided they satisfy (a) and (b).

Lemma 1 and (5) immediately yield the following.

Proposition 1. *Let* $\hat{q} = \frac{X - e - \bar{c}}{\bar{c}}$, *and let A1 hold. Then:*

(i) *there exist distribution functions for* q *satisfying A2 which would make the donor prefer conditional grants,*

(ii) *if* $\left[\frac{1-l}{l} < \hat{q}\right]$, *then every distribution function for* q *satisfying A2 would make the donor prefer conditional grants,*

(iii) *if* $\left[\frac{1-l}{l} > \hat{q}\right]$, *then there exist distribution functions for* q *satisfying A2 which would make the donor prefer unconditional grants.*

By Proposition 1(i), regardless of the values of the known parameters *X*, *e*, $\bar{c}$ and l, there will always exist prior beliefs which would justify a tough love charity policy. Intuitively, the donor need only expect the proportion of *s* agents to be sufficiently small. If the upper bound for the proportion of unproductive agents is sufficiently high, then it is not possible to hold beliefs involving very high proportions of *s* agents. Consequently, all possible prior beliefs regarding the distribution of q, which are independent of the proportion of *u* agents, must justify conditional aid (Proposition 1(ii)). If it is known that the proportion of *u* agents is relatively low, i.e. l is low, and one expects the proportion of *s* agents to be high this would justify unconditional aid (Proposition 1(iii)). Proposition 1(i) implies there would exist other beliefs in this situation that would justify tough love.

4. CONDITIONAL CHARITY

Suppose that the donor has beliefs that lead her to offer conditional grants (Proposition 1(i)). All *s* and *w* agents will apply and, if successful, will implement adjustment. However, no *u* agent will apply. Thus, the true value of p_u will be revealed. However, since the other two types pool, no other information will be revealed. Hence the donor would not be able to update q_E (by (5) and A2). Thus, she would have no grounds for switching to unconditional grants, not even if the true value of q is greater than $\hat{q}$.

Notice that if $\left[\frac{1-l}{l} < \hat{q}\right]$ no observer whose beliefs satisfy A2 will have any reason to question the donor's tough love policy, even if her beliefs differ from the donor's (Proposition 1(ii)). In this case, the objective distribution might warrant unconditional charity, yet there might persist a very broad consensus among outside analysts that the donor's choice of conditional charity is indeed optimal. For this to occur, the observed proportion of *u* types must evidently be significantly lower than l. Thus, somewhat counter-intuitively, tough love policies may be sub-optimal, yet supported by a large majority of independent analysts,

precisely when efficiency gains through better targeting are initially presumed large, but are later revealed, through such policies, to be actually relatively small.

Suppose now $\left[\frac{1-l}{l} > \hat{q}\right]$ and the donor's beliefs lead her to offer conditional charity. There might now exist some independent analysts with beliefs satisfying A2 who, on the basis of their beliefs, would suggest unconditional charity (Proposition 1(iii)). Note now that such a critic, who has the same information as the donor, but suggests unconditional grants on the basis of a different subjective q_E, would have no reason to revise her opinion on the basis of the revealed value of p_u. It follows that, in this case, where the proportion of unproductive types is initially known to be small, there is likely to be significant, but *inconclusive*, debate about tough love policies, once implemented.

In sum, once a donor adopts tough love policies, she is likely to persist, even when such policies are objectively sub-optimal and subject to criticism by independent analysts.

Remark 4.1. Tough love charity screens out all unproductive agents in the indigent population in our formulation. Suppose now that one could find some action-independent observable characteristic, say gender, race, age or geographic location, which was common to all agents thus screened out. However, no productive recipient was found to share this characteristic. If this pattern was found to persist over time, the donor could then shift to a policy of indicator targeting, i.e., provide unconditional grants to all poor agents who do not have this characteristic. Indicator targeting would then maintain the targeting gains from tough love policies, while entirely eliminating its costs. Thus, it is conceivable that in particular policy contexts, a move to indicator targeting utilizing information made available by tough love targeting may lead to efficiency improvements.[18] This may explain why some donors use governance

indicators, e.g. corruption or democracy, although one would have to be very confident that the indicators were indeed powerful discriminators between types before recommending such actions.

18 Political or legal constraints on such a move are an entirely different issue, from which we abstract.

5. UNCONDITIONAL CHARITY

In the preceding section we showed that, given our assumption about priors, tough love charity is necessarily self-sustaining. Our point is *not* that, under our assumptions, any charity policy is immune to contradiction. We now proceed to show that unconditional charity need not be self-sustaining.

Suppose that $\left[\frac{1-l}{l} > \hat{q}\right]$ and the donor's beliefs make her offer unconditional grants (Proposition 1(iii)). Then, all agents will apply. If successful, only *w* agents will adjust. Since adjustment is observable, and since, with random allocation, the donor knows *k* proportion of each type has received a grant, the true value of p_w will be revealed. Since the other two types pool, their exact proportions will not be revealed. However, the revealed value of p_w allows the donor to infer the sum of the proportions of *s* and *u* types. She may be able to use this piece of information to update her expected value of q_E, and possibly, change her policy stance. Example 5.1 below illustrates this possibility.

Example 5.1. Suppose $l = \frac{1}{2}$, and suppose initial beliefs are given by: (i) given any $p_u \in \left(0, \frac{1}{2}\right]$, $q \in \left\{\frac{1}{2}, 1\right\}$ with equal probability, and (ii) $p_u \in \left\{\frac{1}{4}, \frac{1}{2}\right\}$ with equal probability. These subjective beliefs satisfy A2, $q_E = \frac{3}{4}$. Suppose $\hat{q} < \frac{3}{4}$, so that the donor chooses unconditional charity. Then p_w is revealed in the equilibrium, say, as $\frac{1}{4}$. The donor now knows that $p_s + p_u = \frac{3}{4}$. She must now update q_E to $\frac{1}{2}$. If $\frac{1}{2} < \hat{q}$ the donor would then switch to tough love policies.

Remark 5.2. Example 5.1 shows unconditional charity is more *fragile*, in the sense that donors who choose such a policy may subsequently change their mind on the basis of evidence revealed by the equilibrium. This stands in sharp contrast to the enduring character of tough love policies, as discussed in Section 4. Thus, donors who wrongly provide

unconditional charity may sometimes subsequently correct themselves, but donors who wrongly provide conditional charity will never do so. Note that unconditional donors may change their transfer policy even when such shift is objectively wrong.

Remark 5.3. We have assumed that it is too costly for donors to observe individual output. For conditional transfers, ability to observe output would provide no additional information, since the productive types generate identical outputs, and the unproductive ones identify their proportion by self-selecting out anyway. Thus, the initial policy would persist even if the donor could observe outputs. However, for unconditional grants, observation of outputs would allow the donor to infer the true value of p_u, and thereby generate the socially optimal policy. Thus, in this case, an initial policy of unconditional grants would subsequently allow the donor to implement the efficient policy.

Remark 5.4. What happens if the prior distribution of q depends on p_u, so that A2 is violated? The donor who offers conditional aid may then alter her distribution of q on the basis of the observed value of p_u, and consequently switch to unconditional charity. Unconditional charity continues to remain fragile as before, for reasons already discussed. Thus, both forms of charity may be reversed when the prior beliefs fall outside the class characterized by A2. As is well known in other contexts (see Morris, 1995), the subjective distribution need not necessarily converge to the true distribution.

6. DONOR MULTIPLICITY

As discussed in Sections 4 and 5, tough love policies would only reveal the true proportion of unproductive types, while unconditional charity would reveal the proportion of weak but productive types. It follows that if one could somehow subject identical populations to both types of policies, one would then have adequate information for determining the efficient policy. This would be possible if one studies the equilibrium immediately before and after a policy switch, as the indigent population is likely to stay relatively invariant over a short time period. However, since conditional charity is persistent, one would expect the indigent population to change over time even though the aid policy remains invariant. Consider

therefore a situation where tough love policies have persisted for a prolonged period. How would one then ensure that the optimal policy is indeed being followed? Evidently, the donor herself, since she believes tough love is efficient and has no reason to change her mind, is unlikely to experiment with unconditional charity. A different donor, with different beliefs, might (but only if $\left[\frac{1-l}{l} \geq \hat{q}\right]$, recall Proposition 1(ii)). Thus, donor competition with identical indigent populations would be required. This suggests a broad policy case for encouraging multiplicity of charitable donors serving separate but similar clientele.

A caveat is in order. Such multiplicity is difficult to achieve in many policy contexts, for two reasons. First, economies of scale often entail sole provider status for donors such as the IMF, the World Bank, or national governments. Alternatively, it is generally the case that there is a 'lead donor' in any context. Second, behavioural responses by aid recipients may make the indigent populations non-comparable even when the charity market is contestable. To see this, suppose two rival charities, *A* and *B*, initially face identical indigent populations. Suppose *A* opts for conditional charity, but not *B*. Then all *s* and *u* types in *A* have an incentive to migrate to *B*. If at least some agents of both types do manage to migrate, then the revealed proportion of *u* types in *A* will not be the true value for the indigent population as a whole. Since some *s* types also migrate, one would not be able to use this revealed value to infer the true value either, even if one knew the exact number of migrants. Such migration across donor jurisdictions is likely to be significant in many policy contexts.

7. CONCLUSION

Over the last two decades, in many different contexts, donors have largely shifted from a policy of unconditional transfers to one of requiring recipients to undertake some costly prior action. Independent long run contributions of these actions towards improving recipient income are however often quite dubious.[19] Why have donors come to insist on these actions, whose direct impacts on recipient poverty are often contingent and opaque? One standard

19 For an illustrative discussion in the context of the increasing foreign donor thrust on community participation preconditions for aid to anti-poverty projects in developing countries, see Platteau (2003).

answer is that donors have come to independently value these activities. Thus, some argue that the IMF has come to value free markets quite independently of their growth consequences, the European Union has come to valorize religious freedom independently of its impact on income, or that the Grameen Bank fetishizes group solidarity.

Another line of argument, standard in economics and explored in this paper, is that recipients inherently differ in their productivity. Unconditional charity provides indiscriminate benefits; some who would better use the charity do not receive it, while some who would not use it well do. Conditional charity eliminates those who will waste the funds, but imposes a welfare loss, as at least some recipients are required to undertake prior actions that impose a net cost. Those who believe that the proportion of inherently unproductive recipients is relatively high, or that the proportion of productive recipients for whom conditions are wasteful is low, will consider this potential loss low relative to the selectivity gain, and therefore favour tough love. Those who believe otherwise will disagree. At the heart of this difference lies a fundamental dispute over whether the poor are poor due to factors largely intrinsic to them, and whether these factors can be eliminated to a large extent through donor-imposed conditions.

Our analysis suggests that unconditional charity is fragile, in that it may throw up information that would induce a donor to switch to conditional charity, regardless of whether such a switch is objectively warranted. Thus, our analysis provides an alternative explanation for the switch in transfer policy mentioned at the outset, but also offers grounds for agnosticism in relation to its efficiency claim. Our analysis further suggests that, when floor-based voluntary conditionality is not feasible, the practice of conditional charity, once instituted, will not yield information adequate to refute its efficiency claim. Consequently, tough love may persist even when it is inefficient. Unconditional charity, in contrast, may sometimes be self-correcting when wrong. Our
analysis also provides some grounds for encouraging donor multiplicity. Furthermore, we offer some theoretical support for a charity policy of conditionality with a light touch, where the focus is on monitoring the use of resources and complementary activities being implemented that enhance transfer effectiveness, through flexibility, dialogue and partnership with recipients (see Morrissey, 2005, for a discussion of this approach).

It follows from our analysis that an attitude of scepticism in relation to tough love policies might be in order. Much of the literature analysing specific examples of such policies has concentrated on calculating the extent of targeting gains achieved, i.e., the proportion of less productive agents eliminated. What has often been ignored is the idea that tough love policies may also impose activities on many poor nations or individuals that, while quite costly, may also be quite peripheral to the root causes of their poverty. If these costs are significant, then even large magnitudes of targeting gains need not justify such policies. Greater independent assessment of the costs of these activities, and of their connections with income gains (a connection often uncritically assumed positive in the literature), appear to be necessary to provide an adequate justification for many existing tough love policies. Furthermore, whether suitable indicator targeting, which avoids imposing adjustment costs on recipients, can approximate targeting gains from tough love policies appears to be an open question.

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