The Principal-Agent Problem in Development Assistance and its negative Impact on Local Entrepreneurship in Africa: Time for New Approaches in Africa

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Abstract

The following article describes the principal-agent problem in international development assistance. It shows how this problem leads to a top-down approach in development projects which may discourage local entrepreneurship and ultimately undermine sustainable poverty alleviation strategies. The author argues that African countries suffer most from this problem because of their high level of aid dependence. A change in the rules of the game of project-oriented development assistance could help tackling the issue by setting the incentives right. Entrepreneurship and technology may then become tools of social, economic and political empowerment and facilitate more endogenous development that is driven by successful local initiatives rather than foreign aid programs.

Introduction

The essential paradigm for the analysis of market behaviour is that economic agents pursue, at least to some extent, their private interest. It would therefore be foolish to ignore the role of private incentives even in a field such as international development assistance.

Development assistance is largely based on a two-stage delegation process of tasks, which is related to the Principal-Agent Problem (PAP) in institutional economics. This two-stage delegation process causes high transaction costs and unintended outcomes in development projects: the first delegation of tasks happens in the developed country where the donor/public contractor pays an Organisation Involved in Development Assistance (OIDA) to carry out projects in developing countries that contribute to sustainable poverty alleviation. The second delegation of task occurs within the developing country where the respective OIDA hires a local partner to realize a development project.

Delegation always implies conflicting objectives between the agent (e.g. the OIDA) who has been selected for his or her specialized knowledge and the principal (e.g. the donor) who pays the agent but can never hope to completely check his or her performance (Arrow 1963). The agent may use the information advantage to take an action unobserved by the principal (moral hazard) or conceal the true cost or valuation of his work (adverse selection) (Laffont and Martimort 2002).

The first part of this article explains how the market for international development assistance currently works.

The second part then highlights the principal-agent or 'delegation' problems in this market and how they result in wrong incentives and ineffective outcomes in development assistance.

The third part outlines in detail why the principal-agent problem in development assistance undermined the role of higher education, technology and entrepreneurship as engines of endogenous development, especially in developing countries that are highly dependent on foreign aid.

The fourth part comes up with a possible new approach in development assistance that would be able to circumvent the principal-agent problems by changing the institutional setting of development assistance. Most of the long-term successes in development assistance are actually based on the fact that they have emerged outside the realm of traditional development assistance and therefore in an institutional setting that is more conducive to local entrepreneurship and less vulnerable to the principal-agent problem. Successful examples are microfinance (The Economist 2005), low-cost mini-tissue culture laboratories (Aerni 2006), developmental financial institutions that offer venture capital for local technological innovators (George and Prabhu 2003), the promotion of small and sustainable businesses that generate revenues in the poorest regions because they know the local demand and/or discovered an innovative and sustainable solution for a local problem (Gupta 2005), etc. What they all have in common is that they were developed by 'searchers' in developing countries rather than the 'planners' in developed countries (Easterly 2006). Only at a later stage, when the success of the new approach became undeniable it was adopted and marketed by the planners of OIDAs. Unfortunately, OIDAs then often tend to mix the simple business idea with idealistic principles that often prove to be more costly and less effective (The Economist 2005).

The fifth part puts forward the argument that higher education, technology and local entrepreneurship can be mobilized for sustainable development by changing the institutional settings. It would not just lead to more local empowerment and endogenous economic change but also facilitate good governance in the long run. This because good governance cannot be imposed from outside but is eventually induced through internal pressure from a tax-paying and politically empowered middle class within the country. This middle class, again, is a result of social mobility and the continuous build-up of human capital through smart domestic policies. Countries in continental Europe, for example, must only look at their own history to realize that the foundation of their welfare state and their stable democracies is based on human ingenuity and the emergence of an entrepreneurial middle class in the 19th century (Mowery and Nelson 1999). The emerging graduation of many East Asian countries from a developing to developed country status is once again a confirmation that this insight also applies to the 20th and 21st century. It is therefore time for international development assistance to experiment more with new approaches that take these insights into account.

The paper concludes that the ongoing initiatives to eliminate hunger and poverty must address the Principal-Agent Problem (PAP) and design institutional rules of development assistance that are more conducive to bottom-up approaches. Otherwise it is be highly unlikely that the ambitious UN Millennium Development Goals will ever be achieved in 2015.

1. The market of international development assistance

International development assistance does not just represent a genuine effort to improve the situation of the World's poor but also represents a market in which participants have strategic interests and respond to economic and political incentives. The private actors in development assistance (e.g. religious charities, international NGOs, development consulting firms) may be active in developing countries but they tend to be based in developed countries where they compete for funding from private donors and public contractors.

The national agencies for development assistance in developed countries are the main public actors. They are not just running their own projects in developing countries but also provide funding to private actors and international organisations that are active in developing countries.

If these private and public actors in development assistance want to maximize their budget they need to win the public's favour by permanently appealing to people's feelings of compassion and solidarity with the World's poor. At the same time, they need to take into account the general public concerns about globalization and set their priorities accordingly in developing countries (Aerni 2006).

The demand in the market for international development assistance thus comes from private donors and tax payers in affluent countries who want to spend money to help the poor. The supply, in turn, comes from Organisations involved in International Development Assistance (OIDAs) such as NGOs and national agencies for development assistance. The donors/taxpayers are therefore the principals (contractees) whereas OIDAs are the agents (contractors)[1].

At first sight this market logic makes perfect sense: there is a demand among affluent people to contribute to the improvement of the world (more justice and sustainability, less poverty and hunger) and OIDAs offer the respective supply in form of development projects that fulfil first of all the expectations of these affluent people.

Yet, the purpose of such a market is not primarily to eliminate hunger and poverty in developing countries but to address the concerns of the donors in affluent countries who want to be reassured that they did something against world hunger and poverty. This does not mean that the people who work for OIDAs are not genuinely driven by the desire to alleviate hunger and poverty but if they want to stay in the market for donations they need to focus on donor perceptions. If the fight against poverty would be the primary goal then the poor should be, in theory, the principals or clients (because their needs are supposed to be addressed) rather than the donors. OIDAs (as agents) would then be accountable to the poor rather than the donors.

Representatives of OIDAs would object to such an argument and point out that the poorest of the poor do not have the means, the education and the knowledge to be the principals in the game. At the same time they would emphasize that the priorities of the poor are already taken into account through participatory projects. Moreover, their capacity-building activities would increase the knowledge base and empower local people to help themselves and become active in politics. This approach is called 'help for self-help'. The term may sound plausible but it cannot conceal that the principal-agent problem, probably the most important principle in institutional economics, is largely ignored in such projects – and this explains why many of these participatory approaches and capacity-building activities continue to mirror the concerns and ideologies of affluent people in developed countries rather than the poor in developing countries.

2. The Principal-Agent Problem (PAP)

The Principal-Agent Problem (PAP) relates to the problem of asymmetric information in a contract relationship. It gained wide prominence with the work of Nobel Prize Winner George A. Akerlof and his article ‚A Market for Lemons' published in the Quarterly Journal of Economics in 1970. The general argument of this article was that the agent (employee, salesman, contractor, manager, etc) is better informed about a specific task or project to be executed or the product to be sold than the principal (employer, client, customer, shareholder, etc). The agent uses this information advantage to further his own interest at the expense of the interests of the principal.

In project-oriented development assistance the PAP appears not just once but twice:

1. between the donor (principal) and the OIDA (agent) in the affluent country

2. between the OIDA (principal) and the local partner (agent) in the developing country

1. The PAP between donor/taxpayer and the OIDA in the affluent country

In an affluent country, the organisation involved in development assistance (OIDA) is better informed about its ongoing projects in developing countries than the private donors or taxpayers (the clients/principals that pay for it) in the respective affluent home country. The major goal of the OIDA is to give its clients the feeling that they did something good for the poor (by contributing to 'help for self-help'). This ultimately secures the continuous flow of income for the OIDA. It is therefore not surprising that the brochures and annual reports designed for the clients and the mass media never really cover failures but only the presumed successes in the ongoing fight against poverty. In this context, OIDAs highlight for example successful evaluations of projects that helped improve local health care, primary education or sustainable farming practices. However, these project evaluations are mostly carried out during the funding period. How the situation looks like five or ten years after the funding period (when 'help-for self-help' is supposed to 'kick in') is hardly ever known. Another result of the principal-agent problem is that OIDAs prefer to start new projects rather than continue or improve old projects; this because donors respond more positively to visible changes (e.g. a new medical station or school) than to mere descriptions of operation and maintenance activities of existing projects (Easterly 2001). This is a reason why so many medical stations in Africa lack trained doctors and medicine, and schools lack trained teachers and books. This is not to deny that the funding was meant to promote the principle of help-for-self-help, but it is not surprising that the supply of input to run the newly established facilities comes to a halt once the funding stops. There is hardly ever a clear strategy how locals might eventually raise sufficient revenues on their own to run the facilities themselves.

If the national agency for development assistance (which itself acts as the agent of the taxpayer) subcontracts development work to an independent NGO, an additional principal-agent problem might emerge within the group of OIDAs through the process of delegation: the independent NGO (as agent) is only indirectly accountable to the original principal (which is in this case the taxpayer and not the private donor). The fact that principals are hardly ever in a position to find out about the failures and the actions that are not conducive to the ultimate goal of sustainable poverty reduction are clear indications of the potential of moral hazard and adverse selection in development assistance.

2. The PAP between the OIDA and the local partner in the developing country

The second PAP occurs in the developing country, where the OIDA is the principal and the local partner is the agent. In this case, local partners are better informed about the particular local circumstances and they will engage in 'adverse selection' by only passing on the information that serves their personal or family interests (e.g. securing their well-paid position within the foreign OIDA). In this context, it also makes sense for the local partners to embrace the world view and interests of the OIDA rather than the interest of the local community as a whole.

2.1 Resistant to reform?

Over the past three decades, many public and private institutions worldwide identified the PAP at the root of institutional inefficiency caused by moral hazard and adverse selection, and they all reformed their rules of governance correspondingly. These reforms did however not happen in international development assistance even though there is wide evidence that the failure to respect the PAP in development assistance leads to wrong market signals, the misallocation of scarce resources and, ultimately, an unsustainable form of long-term poverty alleviation. William Easterly pointed out (2001, 2006) that OIDAs managed to avoid addressing the problem over the past decade by trying to solve all problems at the same time and adopting a competent and positive development language (e.g. 'mistakes happen but they are addressed by now'). This again helps to avoid accountability and the superficial reforms never reached the root of the problem.

Yet, it must be admitted that it is far more tricky to address the PAP in development assistance than in other organisational forms of society. This is because the poor cannot act as principals as long as they are not able to pay OIDAs for their services. The donor may be willing to put a local entrepreneur in charge of a project who would focus on real local demand in order to generate local revenues. But how can they know that this local person has the ability to succeed and act responsibly?

Moreover, donors want to feel good about their support for development. OIDAs are very professional in quickly delivering tangible positive results that show that the money helped the poorest of the poor; they also learned how to shield donors from being exposed to negative long-term results (e.g. when a project crumbled after the end of funding). This is much more rewarding for a donor than the sponsoring of highly unpredictable local entrepreneurs. In addition to that, educated and innovation-driven entrepreneurs are often hard to find in rural areas of developing countries due to the absence of institutions of higher education that are able to generate the useful human capital and financial institutions that help convert new knowledge and business ideas into goods and services (Juma and Yee-Cheong 2005).

3. The neglect of higher education, technology and entrepreneurship as collateral damage

Remembering the importance of endogenous development

The economist Joseph Schumpeter (1942) already provided empirical evidence that economic and technological change may result in more complexity (new challenges and opportunities, new knowledge, etc.) and uncertainty (new potential risks, less job certainty, etc) in the short-run, but, on the long-run, creates improved conditions for everyone. It is hard to contradict the argument that endogenous development powered by domestic technological and economic change ultimately creates the wealth necessary to fund the modern welfare state in affluent societies. After all, that is what happened in Europe.

At the same time Schumpeter recognized that the resulting welfare state will lead to a changing attitude toward change: the benefits of change are taken for granted while its risks are increasingly becoming unacceptable to society. The resulting scepticism towards technological and economic change as engines of globalization then leads to the general attitude that developing countries 'should not commit the same errors'.

Yet, this well-intended goal to protect traditional communities in developing countries from the 'destructive' forces of the market economy and modern technology leads to the unintended consequence of marginalizing these local communities even more. By focusing their support on the preservation of indigenous products and knowledge and by encouraging them to radically defend local identity and the sovereign use of local resources, OIDAs often discourage exchange with and fuel distrust toward the outside world. This, again, strengthens the power of traditional and conservative forces in local communities at the expense of those who would prefer exchange and development. As a result, the entrepreneurial and curious types in the local community - 'the searchers' as Easterly suggests (2006) - who long for change and new opportunities, will be forced to try their fortune elsewhere and this mainly because of outside 'planners' with good intentions. The exodus of these people in return weakens local sovereignty because the dependence on outside help increases (due to the lack of home-grown entrepreneurs). Moreover, it cripples genuine endogenous development that is based on change that comes from the bottom up.

Remembering the role of universities as engines of change

Over the past three decades, OIDAs tended to neglect the role of universities as engines of social, cultural and economic change in developing countries. This may also be attributed to the PAP since donors and taxpayers back home are expected to see their money being invested in projects that help the poor rather than students at universities and their personal careers. However, there is a mistake in this kind of reasoning: the poor cannot be helped on the long-run unless their offspring is allowed to contribute to economic development (and to support their kin) by pursuing an individual career through higher education and the subsequent search for business opportunities.

At the moment the average quality of education and research at African universities is low due to the lack of access to new knowledge and the long neglect not necessarily by their own governments, but the donors that advise them. The lack of access to new and relevant knowledge again explains why the local private sector does hardly ever see any benefit in collaborating with local universities. The lack of quality and local relevance in research and education again lowers the value of a university degree and makes it difficult for graduates to get a job in the private sector. Moreover, entrepreneurial graduates have no access to venture capital that would allow them to set up their own business (unless they descend from rich parents with a big business network).

As a consequence, universities are unable to generate the human capital necessary to promote sustainable economic growth. Moreover they cease to be ladders of social mobility. Low social mobility again strengthens established interests and prevents a society from renewing itself.

If donors and taxpayers in rich countries would look at their own history of economic development they would realize that their stable democracies and their prosperous economies (that rely on human rather than natural capital) ultimately have their roots in the dynamic and healthy universities that were set up mostly in the 19th century (Mowery and Nelson 1999). If this fact would be more emphasized in education and media coverage in developed countries it would also change public attitude in these affluent societies and ultimately allow self-interested OIDAs to pursue more integrated poverty reduction strategies that include the mobilization of domestic human capital through a more responsive system of higher education.

3.1 Strengthening the role of the entrepreneur as agent of change

The principal-agent problem (PAP) in development assistance and its negative impact on local entrepreneurship and the quality of higher education could be addressed in Africa with new approaches that are based on a different set of institutional rules. The following section will outline a possible approach that is based on institutional rules that take into account the PAP.

Setting up Funding Pools for Endogenous Development (FDEPs)

A possible approach could be the creation of international funding pools for endogenous development (FDEP) designed to strengthen the role of entrepreneurs as agents of change in local communities. FDEPs would be funded by private donors, stand in direct competition to each other and preferably be run by professional venture capitalists. The major goal of such a FDEP is to identify local entrepreneurs in Africa with a potential to set up a successful business in their home region. The overall goal of such a pool would be to generate entrepreneurs that are able to make profits by offering goods and services that meet a local demand. It might then encourage other locals to start a business. The successful graduates then become alumni. They are expected to return a tiny share of their annual profit to the pool and thus contribute themselves to the generation of new local entrepreneurs. The more entrepreneurs a FDEP is able to generate the more revenues it receives from these former graduates and the more attractive it becomes for private donors who are interested in alleviating poverty by promoting endogenous development. At the same time unsuccessful FDEPs that failed to generate a high rate of local entrepreneurs will become less interesting for donors and may eventually go out of business. This would create a genuine competition among these pools that is based on performance. State development banks in India may have come closest to the idea of an FDEP (even though those that failed hardly went out of business). These banks often supported innovative entrepreneurs with backgrounds in science and engineering and thus helped generate many homegrown companies that contributed to technological innovation (George and Prabhu 2003)

A successful FDEP must have effective and experienced scouts in African countries that identify promising entrepreneurs and assist them in the creation of a business plan[2].

The business plan must contain a clear strategy on how to become a profitable and sustainable local business. The scout would also provide the applicant with a list of locally active companies and development organisations and their core competencies (or the products and services they offer). Once the business plan has fulfilled the formal requirements, the local entrepreneur will be paid out by the FDEP mostly in the form of vouchers. These vouchers would enable the local entrepreneur to make initial investments by purchasing products, services, and know-how from the companies or development organisations (s)he considers to be useful in the implementation the business project. The pool itself would then pay these companies and organisations in cash upon producing the vouchers received from the local entrepreneur.

There will also be checks and balances. The scout will get a pay rise with every new entrepreneur he or she has assisted successfully in building up a locally profitable and sustainable business[3]. The entrepreneur, in turn, has the right to dismiss a local company or development organisation that is not able to deliver what was promised and hire another one. This would force development organisations to become more professional and specialize on the delivery of particular services, products or know-how. The competition with local companies will also make them more focused in meeting demands rather than providing supplies

This sketchy outline may not be able to solve the more complex and bigger challenges in the fight against poverty (communicable diseases, malnutrition, war, natural catastrophes etc). Yet, it would at least it address the double principal-agent problem in project-oriented development assistance and therefore contribute to a more sustainable poverty alleviation strategy in the long-run. The new rules of the game would force OIDAs to look at the poor as their clients rather than recipients (since they are paying them). The donor instead would become a shareholder (principal) of a FDEP (agent) which must deliver in order to survive in the competition with other FDEPs . Unlike with a stock company, the shareholder of a FDEP (who has the intention to donate in order to contribute to the fight against poverty) cannot expect to get annual dividends based on the amount of shares (s)he owns in the pool. Instead, (s)he is expected to make an annual payment to the pool. If the pool starts generating successful local entrepreneurs it will also generate additional revenues for itself. This would then lead to a lowering of the annual payment and signal to the donor that his or her money has started to bear fruit. The value of the shares would increase in turn because it reflects an increase in the price-earnings-ratio for donations; as a consequence, more people may buy shares of this particular FDEP because they promise maximal poverty reduction with minimal amount of investment. The pool idea also has the advantage of putting the local person in charge again as an entrepreneur who must make sure that her or his activities serve the local people because they will have to generate revenues eventually. OIDAs have an active interest in helping the local entrepreneur to achieve this goal if they want to continue to earn money from vouchers and increase their reputation for delivering effective support. So they will invest more in the quality of their goods and services and less in campaigning and advertising for donor money in their home country. As such, development assistance would eventually become a professional service industry for the poor. This service industry for the poor may look less heroic but may be all the more effective. It will also generate new opportunities for graduates of local universities to set up their own businesses and create pressure on the administrators of these local universities to improve access to new and relevant knowledge in order to attract talented students that later might become successful local entrepreneurs who provide new funding.

4. Contribution to Good Governance

Today, most Western donors agree that good governance and an effective poverty reduction strategy should be important requirements for an African country to be considered for debt relief and additional foreign aid. This idea is not new but, as pointed out by William Easterly (2001), exists since the 1960s and strict selection criteria for access to foreign aid have been applied on a regular basis under different technical terms over the past four decades. The concept however proved to be ineffective and is likely to remain so in future because, inadvertently, donors turn out to be part of the problem: once again there is a principal-agent problem (PAP) that frustrates the best intentions. This time, the international donors are the principals and the governments in developing countries are the agents. Most governments are willing to accept the terms set by the different donors, in return for access to foreign aid money and debt relief. Yet, when it comes to implement all the sensible poverty reduction strategies produced in collaboration with foreign donors there is hardly any evidence that it works better than 30 years ago. Moreover, international donors often proved to prescribe the wrong medicine with structural adjustment programs that encouraged governments to trim their budgets by cutting back on their expenses for essential public goods such as higher education and infrastructure.

The PAP could be eliminated again through a change in the institutional setting: Instead of just allowing developing countries to write off their debt entirely (which actually creates further incentives to become indebted again) foreign creditors and donors could insist that they pay the annual interest of their debt, but not to the creditor's account but to an independent funding pool specifically designed to improve the infrastructure for entrepreneurs in the respective developing country. It would then essentially complement the activities of the aforementioned FDEPs. In the long run, this might help generating more successful entrepreneurs and stimulate endogenous development. This, again, would lead to a prosperous and politically active tax-paying middle class who would want to have a say as to how their tax money is being spent. If they think the government is doing a bad job by simply wasting resources and not addressing the urgent problems in the country, they will mobilize politically and make sure the incumbent government is voted out of power.

There is abundant evidence from Asian countries that it has always been the middle classes rather than radical political movements that were able to get rid of corrupt governments and improve transparency and accountability of elected governments (Curtis 1997, Aerni 1999). This makes perfect sense from an institutional economics point of view because the principal is no more the foreign donor but the local taxpayer while the agent is still the national government. The local taxpayers know better whether government spending really makes a difference to them and, unlike international donors, they can vote a government out of power if they are not happy with the performance. However, many African countries still lack such a large and politically empowered middle class, and the tax base is correspondingly low (the poor cannot pay and the rich tend to find ways to avoid taxes). Especially in the least developed countries in Africa, where up to 70% of the government budget comes from foreign assistance, it is simply natural that governments have a higher incentive to please foreign donors rather than their own people.

5. Conclusion: Improving the rules for future initiatives

In 2000, the UN general assembly adopted the Millennium Development Goals (MDGs). The overall goal of the MDGs is to cut hunger and poverty by half in 2015. The Five-Year-Implementation Review of the MDGs published by Jeffrey Sachs in January 2005 (Sachs 2005a) is asking for an increase in foreign aid yet without addressing the PAP in development cooperation. This is unfortunate because even the Sachs report admits that little has been achieved in the past five years (the human development indicators only improved in countries with strong economic growth). As a consequence, other development economists such as William Easterly have become impatient with the way development cooperation works (2006). He attacks Jeffrey Sachs' big plan to end poverty (2006) in particular. This triggered a highly polarized debate whether foreign aid is doing more harm than good. But this debate is futile because neither is Easterly asking to stop foreign aid nor would Jeffrey Sachs deny the principal-agent problem in development assistance. Both may agree that creative local solutions are even more important than a global big plan to end poverty. For that purpose, a bottom-up approach is needed to ultimately help achieve the MDGs through the empowerment of local people and endogenous development. A bottom-up approach must be based on institutional rules that deal with PAP and set the right incentives for local initiatives and local governments. Once such rules are in place, entrepreneurship and technology may become the quintessential tools of local empowerment rather than tools of Western domination. The self-replication of local entrepreneurship may also have positive side-effects such as strengthening the local system of higher education and the improvement of accountability and transparency in the public sector. It would bring international development assistance closer to its ultimate goal – namely to eventually become redundant.

Acknowledgements:

I would like to thank my collegues Patrick Kuhn and Sara Küpfer from the Center for Comparative and International Studies (ETH Zurich) for their useful comments on the paper.

Notes:

1. In the developing countries, however, OIDAs play the role of the principal by hiring

2. These scouts may be necessary because unlike job-seekers, entrepreneurs are less likely to focus on advertisements in newspaper because they are busy building up their own business networks outside the conventional market of job supply and demand.

3. A locally sustainable and profitable business must be clearly defined as a long-term venture so that the scout has little incentive to just generate quick profits with the local entrepreneur and then collect his pay rise. Ultimately, a new business that proved unable to generate enough local revenues to make profits to become self-sustaining and a contributor to the generation of new entrepreneurs (through the return of a small percentage of the profit to the FPED) is not a sustainable business.

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