

# NEGLECTED ISSUES IN THE COUNTERPART FUND DEBATE

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## 1 INTRODUCTION<sup>1</sup>

This issue of the Bulletin bears testimony to the recent surge of interest in counterpart funds; and given the size of the current wave of interest in the subject,<sup>2</sup> it might be thought that there is little left to add. There is indeed a clear consensus on many of the important macroeconomic issues. At the same time, macro-economic concerns have dominated the discussion and sectoral issues have been neglected. This article attempts to fill the gap. It begins with a review of the current conventional wisdom (Section 2), continues with a discussion of neglected issues (Section 3) and concludes with principles for an improved approach (Section 4).

The main outcome of the discussion is to give a new emphasis to the developmental function of counterpart funds, placing recipient government strategy at the centre of analysis and focusing in particular on the activities or policies that additional aid either makes possible or prevents being cut. This leads to a sharper focus on the commodity-specific impact on import demand resulting from government expenditure. In addition, policy issues assume greater importance, particularly (and not only for food aid) in the context of potential disincentive and dependency effects.

## 2 THE STORY SO FAR

The question of counterpart funds has generated a large literature on both food and financial aid: Owens (1991) lists over 100 references on different aspects of the problem. However, there is agreement on the basic economics and management of counterpart funds. The conventional wisdom is summarized in Figure 1.

The fundamental point captured by the first two points of Figure 1 is that counterpart funds are not in themselves an additional resource. In economic terms, the resource transfer takes place when the commodities of foreign exchange are sold into the domestic market of the recipient country. At this point, there is indeed a real resource transfer: the sale of the commodities or foreign exchange will transfer resources from the

private sector to the public sector and reduce domestic demand as well as the money supply. When counterpart funds are later spent, there are no new real resources, but the effect is reflationary: a transfer of purchasing power back to the private sector and an increase in the money supply.

On this view, counterpart funds are no more (but no less) than an accounting device, which enables the original donor to exert leverage over the way in which fiscal and monetary adjustments are carried out. In many circumstances, conditionality of this kind will not be necessary: for example, if the donor is in general agreement with the thrust of the country's development strategy. In these cases, it may not be appropriate to create a counterpart fund at all.

On the other hand, there may well be cases where conditionality appears necessary, either because the donor is unhappy with the recipient country's development strategy or because the recipient government finds it politically difficult to protect specific kinds of expenditure. In these cases, it may be desirable to establish a counterpart fund account, although even here, problems of fungibility arise: a donor may find itself funding projects from the counterpart fund that the government would have undertaken anyway, while the original resource transfer is used to fund items (white elephants, cathedrals in the desert, military expenditure) of which the donor does not approve.

If a counterpart fund is to be established, experience since the 1950s shows that certain conditions have to be met for it to be effective. Paragraphs 3 and 4 of the statement of principles list these conditions, which have to do with the size and regularity of aid transfers, the valuation of commodities and the undesirability of allowing counterpart funds to accumulate.

Finally, a number of practical considerations follow from the general principles, summarized in Paragraph 5 of Figure 1: counterpart funds should be planned in advance, credited and spent quickly, subject to the normal procedures for appraisal and managed in as

<sup>1</sup> A considerably longer version of this article was published in June 1991 as *IDS Discussion Paper* No 289, under the title 'The developmental uses of counterpart funds' (Maxwell with Owens 1991). Apart from a general shortening, the main omissions from the present version are discussions of the monetisation of food aid (covered by Schulthes in this Bulletin) and the problems of

conditionality (covered by Fell). The Discussion Paper also contains more detailed proposals regarding the project cycle for counterpart funds.

<sup>2</sup> See especially Roemer 1989, Clement 1989, Bruton and Hill, 1991.

## Figure 1: Commodity aid and counterpart funds. The conventional wisdom

1. The local currency counterpart funds generated by commodity aid are not an additional resource over above the value of the commodities themselves.
2. The generation of counterpart funds provides an opportunity for donor conditionality over the size and composition of government expenditure, with due allowance for the fungibility of budgets. This may be appropriate if there is disagreement about the budget or if government finds it hard to protect essential expenditures.
3. The opportunity for conditionality will be lost if counterpart funds are allowed to accumulate; or if they are eroded by inflation, implicit subsidies or over-valued exchange rates.
4. Conditionality is also more likely to be effective if counterpart funds are predictable, regular and sizeable.
5. It follows that where counterpart funds are appropriate they should be:
  - (a) planned in advance, preferably in the context of a multi-year agreement, linked to other aid and with the possibility of 'substitution actions';
  - (b) credited without delay to a government-controlled interest-bearing account at the full c.i.f. value, before subsidies or deductions;
  - (c) disbursed quickly, following an agreed plan, on deficit reduction or on specific projects approved within the public expenditure programme;
  - (d) subject to the normal procedures for project appraisal, monitoring and evaluation;
  - (e) managed in such a way as to minimise the administrative load on recipient countries, either in a single account for each donor or in a common counterpart fund account, covering several donors.

*Sources:* Roemer 1989, Clement 1989, Bruton and Hill 1991, Goreux 1990, CEGOS-IDET 1989, Knop 1989, 1990, Riley 1990, WFP 1983, 1987a,b, 1990.

simple a way as possible, preferably through a single account or one common to several donors.

The conventional wisdom summarized in Figure 1 offers a sound approach to counterpart fund accounting, albeit one which is rarely implemented in practice. There are, however, three criticisms that can be levied at the recent literature on which it is based. First, there has been insufficient attention to the analytical models of the early discussion of counterpart funds, particularly those dealing with food aid. A major difference is that the early models put development plans much more firmly at the centre of discussion. They began with proposed development projects and then looked at the implications both for total aid requirements and for the commodity composition of such aid (FAO 1955, 1961; Beringer 1964; Dandekar 1965; Srivastava et al 1975). Partly as a result of this difference, project and sectoral issues receive short shrift in the current literature.

A second criticism of the current conventional wisdom is that it deals in aggregate terms with developing

economies in an average year. Apart from the lack of commodity disaggregation, already noted, there is no regional disaggregation in the analysis and very little attempt to deal with the problems of countries where agricultural production, budget deficits, prices and incomes all vary markedly from year to year. In these cases, control of the public expenditure programme becomes much more difficult and counterpart fund expenditures may have disproportionately positive or negative results.

A third criticism is that the current literature does little to address wider concerns, such as growing import and fiscal dependence and potential disincentive effects. Concern with these issues can lead to different approaches, for example to the monetisation of food aid.

In dealing with the criticisms and qualifications, it is important to emphasise that there is no single model of a recipient country, nor any single approach to counterpart fund accounting (Bruton and Hill 1991). Nevertheless, it remains the case that some of the major

recipients of counterpart funds, especially in SSA, are precisely those where the problems of instability, fiscal dependence and potential disincentives are most acute.

### 3 NEGLECTED ISSUES IN THE CURRENT DEBATE

#### 3.1 Sectoral and commodity disaggregation

The implications of putting projects first were demonstrated in the early literature on food aid. In 1953, Nurkse had explored the use of under-employed labour for capital formation in poor countries. Two years later, Ezekiel produced a classic study for FAO (FAO 1955), which examined the potential contribution of food aid to labour intensive development strategies. Here, the strategy came first and the food aid with its counterpart funds came later.

Ezekiel defined two conditions for commodity aid to be effective: a) food or other potential aid commodities had to be the constraint on development in recipient countries; and b) either the increase in consumption of foods had to be as large as the addition to supply or commodity aid had to be supplemented with other aid resources. In practice, Ezekiel suggested that only between a third and a half of the additional demand resulting from a typical works project would be for commodities of the surplus type found in food aid programmes: the remaining increase in demand would have to be met from other sources, notably financial aid or non-food commodity aid.

These conclusions were generalised by an FAO Expert Group in 1961, whose report 'Development through Food', led to the creation of the World Food Programme in 1963.<sup>3</sup> The key steps in the analysis were to estimate total aid requirements in developing countries and then to calculate what proportion of total aid should be made up of food. The Group concluded that about one fifth of total aid could consist of food, with perhaps a third of this providing a subsistence fund for workers employed on capital projects and the remaining two thirds mopping up additional demand during various rounds of expenditure following the original investment.

This kind of analysis became more sophisticated in later years as attention focused more closely on the nature of multiplier effects and on the need for complementary resources. The findings were summarized by Maxwell in 1978 in a table reproduced as Table 1. This shows alternative estimates of the impact of an investment of 100 units on a) total demand; b) the share of food in demand; and c) the relationship between food demand and total investment.

In all cases, it is assumed that the demand for food is entirely met from food aid, so that the total multiplier is heavily damped: without food aid, the same studies show that it would range from 5 to 8, rather than the figure of 2-3 shown in the table (Maxwell *ibid*:9).

The main conclusions of the table are consistent with the earlier analysis in showing that demand for food is only a part of the total demand generated by a works project, between 18 and 45 per cent, depending on the assumptions made. Furthermore, food aid alone cannot meet the total extra demand generated by projects: complementary resources are needed to cover up to two thirds of the total cost.

It is important to note that the assumptions on which this kind of analysis is made are fairly restrictive. Maxwell noted that the increase in demand could be offset in at least four ways: a) by increasing taxation; b) through supply response for particular commodities whose supply is elastic; c) if stocks of food or other commodities can be run down; and d) if the works themselves contribute quickly to increased output.

On the other hand, the analysis is also incomplete in important respects. One is its failure to deal with regional effects. Another is that, reflecting its Keynesian origins, the analysis is driven by consumption linkages. A more sophisticated analysis would recognise that production linkages are also important and that these would have the effect of increasing the multiplier.<sup>4</sup>

Despite the limitations of the Keynesian approach reviewed in the foregoing paragraphs, it does contain three important implications for the management of counterpart funds.

i The importance of commodity disaggregation. The macroeconomic analysis sometimes gives the impression that if a project is to be financed by counterpart funds, there is no difference in terms of monetary aggregates between importing \$100 worth of caviare and \$100 worth of wheat. Indeed, in strictly aggregate terms it is true that supply increases by \$100 when the commodity is imported and that demand increases by \$100 (in the first round) when the counterpart fund is spent. However, the multiplier analysis shows that there will be different effects on the demand for different commodities, which will in turn have an impact on prices and on income distribution between productive sectors and between producers and consumers.

ii The importance of dealing with both direct and indirect effects. The multiplier analysis shows that

<sup>3</sup> A summary of this report is to be found in Singer and Maxwell (1983).

<sup>4</sup> See Evans and Diab 1991 for the use of a social accounting matrix to

investigate production and consumption linkages in this context.

Table 1: Alternative estimates of demand resulting from investment in public works (with food aid)

	Investment (units)	Total demand generated		of which food (units)	Food as % demand (4 ÷ 2 x 100)	Food as % I (4 ÷ 1 x 100)
		(units)	(multiplier) (2 ÷ 1)			
	(1)	(2)	(3)	(4)	(5)	(6)
FAO (1955)	100	161	1.6	48	30	48
Dandekar (1965)	(a) 100	232	2.3	67	29	67
	(b) 100	276	2.8	56	20	56
Beringer (1964)	100	204	2.0	65	32	65
Srivastava et al (1975)	(a) 100	128	1.3	58	45	58
	(b) 100	168	1.7	44	26	44
	(c) 100	195	1.9	36	18	36

Sources and notes: FAO (1955) p.57. Uses Indian data.

Dandekar (1965) pp.48-52. Variant (b) differs from (a) in that recipients of derived demand have a lower MPC. Uses Indian data. Investment in wages only.

Beringer (1964) Table II-1 p.27 and II-2 p.26. Uses Pakistani data, includes some non-food commodities in aid package.

Srivastava et al (1975) pp.22-36. Variants are for low (a), medium (b) and high (c) income countries.

even a project which consists almost entirely of food expenditure in the first round will generate demand for other products in the second and subsequent rounds. This demand may be inflationary (in which case it may have income distribution effects) or it may be translated into imports (in which case the Balance of Payments will worsen). In either case, complementary aid resources may be required. It is particularly important to note that projects funded from counterpart funds, even if their budgets consist entirely of local costs, will generate additional demand for foreign exchange in this way.

iii The need for ex-ante analysis of sector response to increased demand. The literature reviewed suggests that expenditure on projects need not be inflationary if supply response is high or if the project itself generates a rapid return. In these circumstances, providing aid may lead to a disinflationary and disincentive effect.

### 3.2 Inter-annual variability

An important aspect of the real world in which counterpart funds operate has to do with inter-annual variability. In many of the poorest countries, in particular, agricultural production varies markedly from year to year; in most such countries, agriculture is the lead sector of the economy. A good, if extreme case, is Sudan, where agricultural production in the 1980s was severely affected by drought. Between 1982/83 and 1986/87, agricultural GDP fell by 3.9 per cent overall: however, the annual growth rate varied from -23.6 per cent to +28.0 per cent. At the same time, the growth rate of overall GDP varied from -12.8 per cent to +11.8 per cent (Sudan 1988:1). Preliminary figures for 1987/88 and 1988/89 reveal a similar pattern: agricultural GDP fell by 13.8 per cent in the first year and rose by 27 per cent in the second (World Bank 1990:106).<sup>5</sup>

<sup>5</sup> For a general discussion of the importance of treating inter-annual

variability in discussion of food security, see Waters 1991.

Comparing good years and bad years reveals major differences in the environment for counterpart funds. In years of good rainfall, agricultural production is high, as are producer incomes and agricultural labour earnings. Food prices tend to fall, towards export parity if trade is free and to a lower level if it is not; food stocks tend to accumulate. Because food prices play such a large part in the calculation of the cost of living index, inflation tends to be low, although increased incomes may generate excess demand for non-food commodities. The tendency to low inflation is reinforced by the downward pressure on the government deficit: this is caused by the fact that revenues tend to be buoyant in boom years while expenditures on social welfare (including drought relief) are restricted. In bad years, most of these tendencies are reversed. Food prices and inflation generally rise, food stocks are run down, incomes fall and the government deficit worsens, partly because of expenditures on famine relief.

Consider now the differential impact of commodity sales and counterpart fund expenditures in good and bad years. In a good year, the deflationary effect of commodity sales is probably not needed, at least as far as food is concerned. If the food economy is booming and the rest of the economy is not, there may be inflationary or balance of payments pressure in non-food sectors: in this case, non-food commodity aid may be desirable. At the same time, the expenditure of counterpart funds may also be unnecessary: employment and incomes are likely to be high and the government deficit is likely to be low in relative terms, if not in absolute ones.

In bad years, the situation is entirely different. Here, real shortages are likely to develop in the food sector, leading to rising prices and deteriorating real incomes for the poor. Commodity sales could help greatly by reducing inflationary pressure. At the same time, the demands on the government budget will increase, especially if a famine relief operation is required: a contribution from counterpart funds would help to avoid an escalating budget deficit. Putting these two parts of the argument together, monetised food aid could generate a counterpart fund to spend on maintaining food entitlements.

These arguments suggest that commodity aid deliveries and counterpart fund expenditures need to be calibrated according to the state of the recipient economy. In general, commodity aid will be of more use in bad years than in good ones, and this will be more true the more such aid is non-marginal.

If calibration is needed on a yearly basis, there are important conclusions for the management of programme aid, particularly as regards the desirability of multi-annual programming. In the food aid field,

'substitution actions', which replace food aid with cash, have been introduced to help ensure continuity of support in years when food aid is not needed. In import programmes, there is usually a great deal of flexibility built into the programme through the use of positive and negative lists. However, there may be a need to revise the lists to take account of changing domestic conditions.

### **3.3 Fiscal and import dependence**

One reason why continuity of support is needed is that recipient governments may become dependent on the budgetary contribution of counterpart funds. This is not an issue much discussed in the current literature on counterpart funds, but is a major topic in the food aid literature. Nevertheless, as Maxwell and Singer (1981:227) noted, the allegation that aid acts as a 'fiscal drug' is not unique to food aid and it is 'difficult to judge whether food aid is particularly sharply exposed'.

In their review of the literature up to 1977, Maxwell and Singer reported that fiscal dependence had been on the agenda since 1960 and had been a major issue in many large recipients, including India. In one extreme case, Bangladesh, 40 per cent of the national budget in the mid 1970s was derived from food aid counterpart funds.

Fiscal dependence has continued to be a concern in food aid. A recent review of the literature regarding sub-Saharan Africa provided evidence of actual or potential fiscal dependence in Botswana, Lesotho, East Africa and the Sahel (Thomas et al 1989:42). In one East African case, Green suggested that 'the likely restoration of food self-sufficiency in maize in 1985/86 could, in principle, have increased the recurrent budget deficit for 1985/86 by up to \$US100 million, or 30 per cent' (Green 1986:18). This presumably assumes that food aid normally provided would no longer be available: and that no substitution action would be arranged.

Whether or not fiscal dependence is seen as a problem partly depends on the observer's point of view. Some have argued that programme aid which contributes to recurrent budgets is a positive good (Sharpley 1986, Jennings and Shaw 1987). It could be seen as an international transfer payment. On the other hand, some observers would be concerned at a possible disincentive to tax collection; and many developing countries would be concerned about possible dependence on unreliable aid flows.

There are two possible ways out of the dilemma, both relevant to the management of counterpart funds. The first is, so far as possible, to assure continuity of supply of aid, whether directly resulting in counterpart funds or not. This is especially true where counterpart funds

are used to fund recurrent expenditures. Perhaps the balance between support for the development budget and the recurrent budget should depend partly on the reliability of future aid flows. Only aid which is secure should be used to fund recurrent expenditures.

The second defence against fiscal dependence is to look directly at the disincentives to revenue generation. If large commodity aid shipments are associated with lax revenue raising, then there is *prima facie* evidence of fiscal dependency. If, on the other hand, appropriate tax policies are in place and are being effectively implemented, then fiscal dependency is of less concern. However, the argument suggests that commodity aid donors should pay special attention to this item.

A related issue has to do with import dependence. Here also, the argument has largely been driven by the literature on food aid, where the concern is with increasing wheat imports, often associated with large consumer subsidies.

The strongest conclusion that can be drawn from the literature on this topic is that where subsidies are large and where there is no commitment by the government to eliminate generalized subsidies, wheat aid should be withdrawn (e.g. Maxwell 1987). An alternative view is that the granting of food aid should be conditional on a review of food policy and on agreement to a staged withdrawal of inappropriate food policies (e.g. World Bank 1990 on Sudan).

The same argument applies by analogy to other forms of commodity aid, including those covered in general terms by an import programme 'positive list'. The implication for counterpart fund programming is that there needs to be special attention to the pricing arrangements for the particular commodities supplied as aid or to be purchased within import programmes. It may be, for example, that commodity pricing is inappropriate, even though the IMF and the World Bank have approved the thrust of government policy taken as a whole. In this case, the IMF/World Bank 'green light' is not enough to justify commodity aid.

### **3.4 Absorptive capacity and disincentive effects**

The fourth set of issues has to do with concerns about absorptive capacity and disincentive effects and revolves largely around the price of aid commodities.

The starting point is a debate about the absorptive capacity for aid. In the World Bank/WFP report on food aid to sub-Saharan Africa, absorptive capacity is seen to coincide with a level of imports such that 'domestic prices are equal to the real border price (the import price multiplied by the shadow exchange rate)' (World Bank/WFP 1991:19).

The report goes on to qualify this conclusion by referring to the case for price stabilization in some years; and to make the important point that what happens to food prices depends on how aid is used. If food aid makes possible additional projects and if these increase the demand for food, then 'absorptive capacity is limited only by the ability to design and implement new projects and by the domestic or imported supply of non-food commodities' (ibid:20).

In principle, the argument here applies to all commodity aid, not just food aid: if the supply of a commodity is too great, then there are likely to be disincentives to local production. The argument has less force in the case of financial transfers, where the commodity composition of imports is determined by demand.

The important point for counterpart fund managers is that they need to estimate absorptive capacity for commodity aid. This means that they need to assess the effect of the combined commodity supply/counterpart expenditure process on individual commodity prices *ex-ante* and monitor these *ex-post*.

The disincentive debate has been a major feature of the food aid debate for three decades. Schultz argued in 1960 that food aid sold onto a recipient market would depress the prices of the same or competing commodities and that this price effect would have a disincentive effect on local producers. The disincentive effect has been a major area of study since then and four main conclusions relevant to counterpart funds have been reached.

First, food aid cannot be held responsible for disincentive effects if it merely substitutes for commercial imports a country would anyway have made. Only if food aid represents additional imports can there be a risk of agricultural disincentives (Clay and Singer 1985:16). This suggests that it is important to differentiate between commodity aid imports that are additional and those that are not.

Second, the disincentive effect is offset to the extent that the real resource is used to expand demand. This can be done directly, by distributing food to hungry people; or indirectly, by increasing expenditure on poverty alleviation programmes (Stewart 1986; Fitzpatrick and Storey 1989). As seen above, the extra demand for food can account for up to two thirds of the initial value of food delivered. Of course, if food aid is not additional, this increase in demand will tend to be inflationary.

Third, it is important to undertake a careful analysis of price movements. In the earlier literature, any fall in prices was interpreted as a disincentive to local

production. In later analysis, however, it became clear that a fall in price from the high 'scarcity' levels prevalent at times of shortage could actually be a good thing. This led Maxwell to conclude that 'disincentive should be measured not in terms of lower prices, but in terms of 'deviation from optimum prices'' (Maxwell 1991:69).

The implications for monitoring are that a guide price needs to be established, with limits of acceptable variation (ibid). If prices fall outside the range, then remedial action will be necessary: a substitution action or a change to the timing of food aid distribution or sale.

Finally, it is possible for disincentives to occur at the regional level. This is especially likely to be the case where large shipments of commodity aid are made for free distribution or in order to facilitate public works projects (Maxwell 1991:71). Here again, commodity aid managers need to monitor possible negative effects.

#### **4 TOWARDS A COMPREHENSIVE APPROACH**

There are two key principles involved in defining new guidelines for counterpart fund management. The first is that the guidelines should be *practical*. It is already the case that donor policy runs some way ahead of implementation. Substantial improvements to the management of counterpart funds would be possible if donors were only able to do in practice what they already say they would like to do in theory. In this context, there is little point in adding layers of theoretical complexity that would be unlikely to be implemented.

The other principle is that effort by donors to improve management should be *proportional* to the benefits. In particular, this means that some system of thresholds is desirable, so that analysis intensifies as the size of counterpart funds rises relative to the recipient economy. A good comparative example is to be found in the US legislation on food aid. Here, the guidelines governing the Bellmon amendment, which deals with the disincentive effect of food aid, specify that a full disincentive analysis is necessary only if US food aid accounts for 10 per cent of total staple consumption; a less detailed analysis is required if US food accounts for 2-10 per cent of total consumption; and no analysis at all is required if the figure is below 2 per cent (USAID 1985). There is no real analytical basis for these figures and the effects may be disproportionate at the regional level (Maxwell 1991). Nevertheless, something similar may be appropriate in the case of counterpart funds.

Turning to substance, there are three themes to pursue.

The first is the most important: it is to try and shift the discussion somewhat away from the pure macro-economics of counterpart funds back towards a stronger focus on development activities. In this connection, the key questions to ask are what additional activities or policies will the provision of commodity aid make possible, that would otherwise either have to be cut or not be undertaken at all; and what effect will these activities have on the demand for different commodities, on resource use within the economy and on such economic and financial variables as the budget deficit, the rate of inflation, the Balance of Payments account, the growth rate and income distribution.

A second theme is the importance of taking account of year to year variability in the demand for and the possible effects of both commodity aid and expenditures of counterpart funds. Both strict commodity aid and import programmes tied to particular commodities are best planned in a rolling, multi-year framework with annual reviews and provision for substitution actions.

A third and final theme is the need to look beyond the confines of the Public Expenditure Programme to wider issues of policy. This applies both to the planning stage of commodity aid/counterpart fund proposals and to monitoring. If policies are not 'right' then the commodity aid/counterpart fund package will not achieve its objectives; indeed, it may, as in the case of food aid disincentives, actually make things worse.

Finally, there are three research issues which are not less important but which are less operational than those listed above:

i The desirability of modelling work to elucidate the questions of commodity disaggregation and production/consumption linkages discussed in Section 3.1. It would be extremely useful for this to be done using a social accounting matrix, so as to explore income distribution questions in more detail.

ii The need for a better understanding of thresholds, for different kinds of aid at different levels of analysis. It is especially important to have a better basis for thresholds than the rule of thumb derived from the USAID Bellmon amendment guidelines; and to develop rules not just for the national level but also for the regional level.

iii The need for a stronger developing country perspective on the issues, perhaps through locally managed country case studies. These country cases could be particularly helpful if they explored the grey area of competing conditionalities between different donors.

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