



Corruption and aid modalities

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U4 Issue

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Abstract

The introduction of 'new' aid modalities – and in particular general budget support – has increased the interest in the relationship between corruption and aid modalities. This U4 Issue reviews the information that theory and empirical studies provide on the prevalence of corruption in relation to various aid modalities, the degrees to which corruption distorts the developmental impact of different aid modalities, and whether aid modalities affect the governance environment and corruption in a country differently. It concludes that the choice of aid modality will not affect aid allocation nor accountability in countries with relatively low levels of aid, regardless of the level of corruption. With high aid dependency, however, donors have some more control over aid allocation with project than with budget support. Where this is the case, and corruption is high, there are strong reasons for not choosing budget support as an aid modality.

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Introduction

The introduction of ‘new’ aid modalities, and in particular general budget support (GBS), has increased the interest in the relationship between corruption and aid modalities. This U4 Issue provides an overview of available arguments and evidence. It needs to be emphasised that corruption is one of several considerations that are relevant when deciding whether or not to use budget support; other important issues include the degree of aid dependence or the fragmentation of aid flowing to a country, as well as the degree of political commitment to development in the political leadership (which can be distinct from the prevalence of corruption). Furthermore, the primary hinge between corruption and budget support is the management of public expenditures¹. At the same time, it needs to be born in mind that ‘the budget is not everything’, i.e. important fields of corruption may be associated with privatisation or with licensing regimes and hence are not directly associated with how budget funds are being handled. However, as will be discussed in Section 3, cases of high-level corruption can affect budget support, even if there is no claim of a direct misuse of public funds.

At the outset, it is important to recognise that little evidence or even clearly set out arguments are available with regard to: (i) the prevalence of corruption in relation to various aid modalities, and the degrees to which corruption distorts the developmental impact of different aid modalities; and (ii) whether aid modalities affect the governance environment and corruption in a country differently. No comprehensive studies seek to address these issues, but it is possible to identify relevant arguments and material. Furthermore, some of the studies which are relevant have been sponsored by donor agencies – and hence may reflect the diverging views among donors regarding the desirability of budget support.

This U4 Issue proceeds as follows. Section 1 provides a backdrop by looking at the relationship between total aid and corruption. Section 2 briefly reviews the key rationales that have been proposed for providing budget support. Section 3 addresses some of the theoretical arguments that are relevant to issues of corruption and the choice of aid modalities. Section 4 summarises empirical evidence which, though not always addressing the questions posed directly, can offer some initial clues. Section 5 concludes.

1 Donors as a potential cause of corruption

In principle, there are two ways of looking at how donors may affect the level of corruption in partner countries. In the first case, more corruption may result from actions that donors take than in their absence. These are acts of commission. In the second case, more corruption may result from actions donors do not take, compared with those they could have taken. These are acts of omission. This distinction is useful in reviewing the literature on donors and corruption, and the two concepts are discussed in turn below.

¹ Discussed in earlier sections of Kolstad, I., Fritz, V., O’Neil, T. (2008) *Corruption, Anti-corruption Efforts and Aid: Do Donors Have the Right Approach?* London: Overseas Development Institute. Available at: http://www.odi.org.uk/PPPG/politics_and_governance/publications/GAPWP3.pdf

1.1 Acts of commission

Several studies have examined how aid flows affect the level of corruption in partner countries. A basic theoretical rationale for these types of studies is that aid is a type of windfall, which may cause groups and individuals to vie for a portion, resulting in increased rent-seeking activities and corruption. So far, there is no consistent evidence from cross-country econometric studies that aid causes corruption. Knack (2001) finds that aid is positively related to corruption. Tavares (2003), using a more sophisticated approach to the question of causality, finds instead that aid decreases corruption. Dalgaard and Olsson (2006) find that aid decreases corruption at low aid levels, but increases corruption at high aid levels.

Although there is little consistent evidence that aid increases corruption on average, there is evidence that aid may cause corruption in countries with certain characteristics, and that specific donor practices can induce corruption. Svensson (2000a) performs a cross-country study in which aid is interacted with the level of ethnic fractionalisation in a country. He finds that aid increases corruption in countries whose population is highly fractionalised, whereas aid reduces corruption in more homogeneous countries. In other words, where there are many distinct groups fighting for the extra resources that aid represents, aid appears more likely to have a detrimental effect in terms of rent-seeking and corruption.

Similarly, more case-by-case material suggests that there is little doubt that certain donor practices have led to corruption. There are a number of cases of corruption in aid projects. Moreover, well intended conditions imposed by donors have had seriously negative consequences in terms of corruption. A frequently used example is donor-induced rounds of privatisation, which domestic elites have taken advantage of and rigged in order to enrich themselves. Lax donor control and follow up that characterise much humanitarian aid also increase opportunities for corruption (Schultz and Søreide, 2006). And donor behaviour or privileges in partner countries – such as donor tax exemptions – may also in some cases undermine social norms, rather than help build tax compliance.

1.2 Acts of omission

It has been suggested that by not taking an active stance on anti-corruption, and by continuing to give aid and support to corrupt governments, donors are contributing to corruption. Studies of aid flows have corroborated the view that corruption is not necessarily a deterrent to aid. Alesina and Weder (2002) find, for instance, that more corrupt countries do not receive less aid. But there are also differences among donors. Scandinavian countries give more aid to less corrupt countries, whereas the US gives more aid to more corrupt countries.

Some studies of aid to African countries argue that these types of acts of omission are important. In a study of Mozambique, Hanlon (2004a) suggests that, in order to obtain other objectives, donors have in effect turned a blind eye to corruption. In his view, "donors are rewarding what they see as 'good performance' by allowing, and thus effectively encouraging, corruption and state capture". Tangri and Mwenda (2006) present a similar argument for the case of Uganda, where "by giving large amounts of aid to a corrupt and quasi-authoritarian government, as well as being reticent in their public criticism of abuse of power and corruption, donors have abetted the actions of Uganda's leaders in weakening those bodies that hold them responsible for abusing their public positions." Moreover, Mwenda and Tangri (2005) argue that "aid (has) provided the government with public resources to sustain the patronage basis of the regime ... propping up a corrupt government in Uganda." Van de Walle (2001) argues that SAPs allowed neopatrimonial leaders to remain in power by providing external scapegoats and at the same time a source of revenue in the context of severe economic crisis. Incumbent leaders engaged in just enough reforms to ensure the aid flow, while often instrumentalising and/or stalling the reform process. These studies relate the actions of donors to their need for success stories, in order to

justify large amounts of aid. The pressure in donor agencies to disburse aid has been noted by Easterly (2002), but if the above arguments are correct, disbursement pressure and the need for success stories also have detrimental effects in terms of corruption. The implication is that, in addition to governance reform in partner countries, there is also a need for reform to change the incentives in donor agencies.

The degree of omission of due care among donor agencies is also reflected, for example, in the fact that the World Bank created an internal watchdog institution, the Department of Institutional Integrity or INT, only in 2001, and that this institution is finding quite a number of unsavoury practices regarding how World Bank funds are being used. The fact is that the Bank is in 2007 gaining "a deeper and growing understanding of the nature of vulnerabilities to corruption in Bank-financed projects" but that "knowledge of the frequency, scope and depth of the problem is less certain" because "the allegations INT receives are only a subset of the entire universe of corrupt activities, but also because INT has a finite ability to actively investigate all the allegations it receives" (World Bank 2007b). This implies that corruption risks associated with World Bank operations have been rather neglected for almost 60 years of the Bank's existence. Other international financial institutions (IFIs) and bilateral donors appear to be in a similar situation.

2 Budget support, development and governance

Budget support is aid transferred to a partner government's national treasury to be managed by means of the beneficiary's budgetary procedures. In contrast, project support is aid transferred to fund predetermined projects, such as building schools and infrastructure or capacity building. Budget support can be GBS, disbursed in support of the general national budget, or sector budget support, which is channelled towards specific sectors, such as education or health. We focus here on generic issues with regard to budget support and do not discuss specifics related to sector budget support.²

In reality, both budget support and projects are broad categories, lumping together a wide variety of actual practices of aid provision. For example, there can be much variation on the degree of predictability of support under both modalities. Projects can range in size from small (e.g. US\$100,000) to large (e.g. US\$50 million and more). Furthermore, there is considerable variation with regard to actual use of budget support among donors. Some donors – such as DFID or the EC – have been (strongly) supportive, other donors – such as the US, Japan, or Germany – have been more cautious (Strategic Partnership with Africa, 2007).³ Finally, it is important to keep in mind that the choice between budget support and project support need not be a binary one and, in practice, a mix of aid modalities is used. The Paris Declaration (OECD, 2007b) revealed that, for the 34 countries included in the survey, direct budget support accounted for 20.7% of all aid.⁴

Budget support is usually policy-based aid and comes with conditions (and/or a policy dialogue) attached,⁵ which partner countries are expected to follow (for an in-depth discussion of aid modalities and conditionalities see White and Dijkstra, 2003). Accordingly, the objectives of budget support can be illustrated as follows.

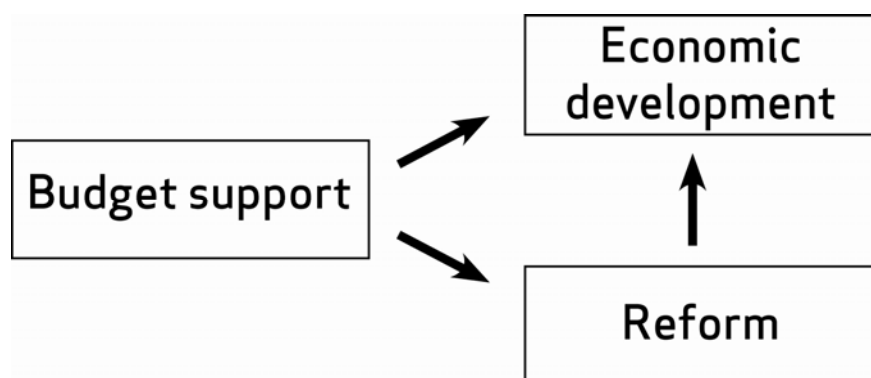
² For a discussion of different types of budget support see Lawson and Booth (2004).

³ Differences in approach are not related exclusively to the relative merit of different aid modalities, but also to donor interests and institutional legacies.

⁴ The Baseline Survey included many countries with more advanced aid management arrangements. Hence the percentage of budget support for all aid recipient countries is likely to be lower.

⁵ Both project and budget support can be linked to reforms (e.g. in economic or state governance), but budget support is often viewed as a way of addressing reform at a more aggregate level.

Figure 1: Twofold objectives of budget support



Source: Based on White and Dijkstra (2003)

Firstly, budget support has the objective of directly increasing economic development. Budget support is argued to be beneficial compared with other aid modalities for several reasons. Budget support is believed to reduce transaction costs in aid delivery. Moreover, if recipient country governments are more informed about specific in-country conditions relevant to aid effectiveness, or more likely wholeheartedly to implement policies in which they have ownership, funds channelled as budget support may be allocated and used more efficiently. In addition, budget support can be one way of improving donor coordination, thus reducing transaction costs for partner countries and the "institutionally destructive effects from the proliferation of donor projects" (White and Dijkstra, 2003). It can also facilitate long-term planning by providing stable and predictable financial flows.⁶

Secondly, budget support is intended to contribute to the strengthening of recipient country institutions and to generate reform in those institutions or policies that can have a positive effect on development. It is argued that budget support may help to improve domestic accountability in partner countries, by using local systems to channel funds and underscoring the budget as the tool and expression of policy, thus facilitating review by local stakeholders (public accounts committees in parliament; external audit offices) and increasing government accountability to the population in the use of public resources. Budget support is also assumed to support a more intensive policy dialogue between donors and recipient countries, more effective use of conditions, and more intense efforts to improve recipient country systems (mainly public financial management and procurement systems). The shift towards providing more budget support has been accompanied by increases in donor expenditure on the reforms of such systems.⁷

3 Corruption and budget support: theoretical arguments

Concerns have been raised about giving budget support to countries where corruption is high. Unwin (2004) argues that "[a]t present, many of the African countries receiving budget support from donors

⁶ However, in reality there can be considerable variation with regard to the predictability of budget support.

⁷ The total spending of donor agencies on public sector financial management jumped from US\$6m in 1990 to US\$150m by 1995, and US\$800m by 2001 (OECD, Creditor Reporting System; in 2002 prices).

are widely described by international agencies as being ‘corrupt’. [...] Donors are therefore taking an immense leap of faith in believing that they can somehow change this system in a couple of years through the use of budget support [...]” Unwin concludes that GBS is likely to be a transient feature of official development assistance (ODA). He does not, however, provide a detailed analysis into the relationship between corruption and aid modalities.

From a donor perspective, a frequently raised concern is that budget support associates donors more closely and more comprehensively with the actions of recipient governments, and consequently involves a greater ‘reputational risk’. Thus, when cases of ‘grand corruption’ hit national or international headlines, budget support comes under greater pressure for (immediate) suspension than project support. This could cause disruptions in aid flows that make aid less reliable and less effective.

From an analytical perspective, two main concerns with regard to corruption and budget support have been raised. Firstly, budget support gives partner country governments greater discretion in the allocation of aid, which could increase rent-seeking and corrupt misallocation, reducing the development impact of aid. For instance, there is evidence that corruption leads to less government spending on education and more on the military (Mauro, 1998). Such allocative incentives could also affect the use of budget support. Secondly, budget support may increase the resources at the disposal of a government and, as a consequence, increase the power of an incumbent government relative to other groups in the partner country. Instead of increasing domestic accountability of a government, budget support could then reduce domestic accountability and retard reform.⁸ Sections 3.1 and 3.2 examine these two concerns in greater detail. Section 3.3 deals with effect of budget support on external accountability, i.e. of partner country governments to donors.

3.1 Aid modalities, corruption and fungibility

Fungibility means that partner country governments can reallocate their own resources in anticipation of aid. For instance, if donors grant US\$1 million to education in a partner country, the government can redirect these funds to other purposes by reducing their own spending on education by US\$1 million. Although the schools nominally funded by aid are built, they would have been built without aid. Aid therefore does not result in more schools being built. Another way to put it is to say that even earmarked aid simply relaxes the general budget constraint of the government.

Aid is more fungible under certain circumstances than under others. The degree of fungibility of aid depends in particular on how much a government would have spent on the activity for which aid is earmarked, compared with the amount of aid given. Aid is less fungible the more aid-dependent a country is, i.e. the greater is the amount of aid compared with government domestic revenues. Furthermore, aid is less fungible the higher the level of aid to sectors favoured by donors compared with government spending. Where aid is small compared with government resources, aid is highly fungible. Where aid funds activities a government would not spend any money on, aid is completely infungible.

Cross-country studies show that high levels of corruption are associated with less government spending on education (Mauro, 1998) and more on the military (Gupta et al., 2001a). Moreover, corrupt governments have been found to over-invest in public infrastructure and under-invest in its maintenance (Tanzi and Davoodi, 1997; Esty and Porter, 2002). This would suggest that, to the extent that budget support leaves more discretion for partner country governments, we would expect the

⁸ However, it may be difficult to distinguish empirically whether this effect is generally associated with the influx of large amounts of aid, or whether it is specific to situations where significant shares of aid are provided as budget support.

funds to be less effectively allocated, in terms of productivity and growth as well as poverty reduction, when a government is more corrupt. The extent to which budget support entails a real increase in discretion depends, however, on the fungibility of aid.

Where aid is completely fungible, earmarked aid or project aid will result in the same allocation of funds across activities and sectors as budget support. Giving aid as project aid will in this case not have any effect on how aid is actually spent. By implication, assuming that the transaction costs of project support are higher than for budget support, budget support is the modality of choice when aid is highly fungible, even in highly corrupt countries.

In countries where aid makes up a large share of public spending, fungibility of aid is generally lower. In aid-dependent countries, donors can exercise greater control over the actual allocation of funds (including aid), in particular through earmarking aid. Where governance is relatively good, the international aid policy debate argues that donors should give greater ownership of the use of funds to governments (see the Paris Declaration, OECD, 2007b). However, where governance is poor and corruption is high, donors may want to exercise control by providing aid through projects or otherwise in earmarked ways (Radelet, 2005). At the same time, as Box 1 below reflects, while the lower fungibility of project aid may be desirable in these cases, donors should not assume that the choice of aid modality alone suffices to ensure that aid is not wasted owing to misallocation and corruption.

In highly aid-dependent countries which are highly corrupt, project or earmarked support would lead to lower fungibility of resources than budget support. The expansion of budget support in recent years has been accompanied by a simultaneous growth in donor efforts to ensure that government funding is channelled towards service delivery. Furthermore, sectoral budget allocations are monitored – and PEFA assessments are used to keep track of whether the sectoral breakdown is actually maintained during budget execution (and not just stated in budget plans). In the way that it has actually been provided, this type of aid has taken a form closer to sector budget support than GBS. If aid is imperfectly fungible, this limits opportunities for governments to shift budget support to other sectors. However, discretion remains in allocation within sectors, which highly corrupt governments can use to choose activities that generate higher rents.

3.2 Budget support and domestic accountability

Theoretical arguments concerning the effect of budget support on domestic accountability are conflicting. On the one hand, it is argued that budget support increases domestic accountability, by bringing aid on budget and thus underscoring the government budget as the statement and tool of policy, and by stressing the idea that government is responsible for allocative decisions. A government that receives budget support becomes more clearly responsible for how the aid it receives is used and is being accounted for. There is a more clear-cut transfer of ownership of resources from the donor to the government. In the case of project support, ownership by the aid donor and the aid recipient overlap; this unclear ownership may result in aid being treated as a ‘free resource’ from which it is ‘legitimate’ to divert. On the other hand, it is argued that budget support may decrease accountability, by giving more resources and hence more power to the central government relative to the agents that hold it to account.

Again, fungibility plays a role – where aid of any form is completely fungible, the aid modality used would generally neither influence the power of the government to allocate funds nor affect the relative power between government and other groups in the country. Where fungibility of project aid is more limited, the choice of aid modality may have an impact. Budget support gives the government more of a say in allocative decisions compared with project support, and its decisions may therefore be subject to more scrutiny and reaction. However, this positive contribution for greater accountability may be counteracted if budget support significantly shifts the balance of power in favour of the government.

Whether the net effect is to increase or reduce accountability is therefore unclear, and depends on the wider governance context.

Where groups and institutions supposed to hold a government to account are weak and marginal, budget support should not be expected to change this situation. Hence, greater ownership of aid by the recipient country government may not result in greater accountability. Moreover, in these types of situations, budget support may even make a government less accountable by increasing its relative power. Both Kolstad (2005) and USAID (2005b) argue that budget support gives greater funds and hence greater power to central governments. Consequently, the USAID report in particular argues that budget support requires complementary projects to strengthen actors that potentially demand accountability. Furthermore, project support can provide one option of providing aid without propping up a government that is corrupt as well as oppressive towards opposition groups.

3.3 Budget support and external accountability

In principle, the choice of aid modality may influence accountability of partner country governments to donors in several ways. One way is to change the interests of donors in demanding reform. The other is to make available more effective means of promoting reform in partner countries. A third question is the ways in which aid funds are being accounted for and audited. In terms of donor interests, a key argument used in favour of budget support is that only by using government systems will donors seriously be concerned with pursuing their reform. This argument is widely used with regard to improvements in public financial management (PFM) and procurement systems (also in the context of the Paris Declaration, OECD, 2007b); it can also be applied to corruption.

To matter, a potential increase in interest has to be coupled with effective means of inducing reform. Donors, broadly speaking, promote reform in two ways: through supportive measures such as capacity building, and through incentives such as conditionality and sanctions/rewards (e.g. withholding aid). It is possible that budget support, through increased donor coordination, makes for more concerted and hence more effective capacity building and incentive practices. However, as donors have found with regard to PFM and procurement reform, external inducements and incentives for reform can have limits where commitment to change of key stakeholders in country is low. Moreover, even where governments are broadly supportive of strengthening PFM systems, they may be less supportive of serious action against corruption – in particular, forms of corruption that are linked to party financing and similar, which are linked to the maintenance of the political system (e.g. in Uganda, see next section).

As for conditionality, budget support is unlikely to remedy the basic commitment problem that limits its effective use. There is substantial disillusionment with the degree to which *ex-ante* conditionality can be an effective means to promote reform, that aid can ‘buy’ reform (see Svensson 2000b). Where partner countries have failed to implement the reforms promised, donors have still found it in their interest to provide aid (often called the Samaritan’s dilemma), and a threat to withhold aid is therefore not credible. The alternative is to use *ex-post* conditions, which entails giving aid only after a country has reached a certain quality of governance. This is to some extent being tried, the US MCA being a prominent example. This type of conditionality does solve the commitment problem to some extent, by replacing donor discretion with an absolute standard that must be met before aid is provided. However, the commitment problem is not necessarily overcome completely, as the standard may be subject to change.

Regarding external accountability, in projects, financial audits can provide a direct form of accountability, but one which is focused on rule-following rather than results. This has often proven to be highly imperfect (see Box 1). In the case of budget support, this route is more limited (once it has been verified that the transfer has gone to the intended accounts). It is really recipient country

institutions – of controlling, reporting on, accounting for and auditing the use of budget funds – that matter.

Uganda provides a recent interesting case: the Global Fund (GF) had provided project support to Uganda's health sector, managed by a dedicated project management unit (PMU). In August 2005, serious mismanagement and corruption was alleged, leading to a large-scale investigation which found that money had been mishandled.⁹ In early 2007, an agreement was reached between the Ugandan government and the Global Fund to resume funding, now using government systems rather than a PMU. The undersecretary of the Ugandan Ministry of Health argued in this context: "At first the GF in Uganda was treated as a project and that is why it ended badly because it was not subjected to government scrutiny" (*The Daily Monitor*, 2 April 2007). Thus, the responsibility for the funds and for accounting and auditing was shifted from mixed – and blurred – ownership to full government ownership, which now becomes responsible for accounting for the use of these resources in the health sector. Whether this will solve the issue remains to be seen.

Box 1: Corruption and project aid

Corruption has been discovered in numerous aid projects over the past years and decades. Furthermore, corruption also has been found to be internal to international agencies (especially the UN system, EC, AfDB); there is increasing attention also to corruption in humanitarian relief (Ewins et al., 2006). Several donors have guidelines about how to prevent corruption in project aid – indicating that corruption is considered a risk (Aguilar et al., 2000).

For project assistance, the prevalence of corruption is driven by the nature of the projects that agencies typically deal with (size, sector, etc.) and the quality of internal processes and of processes for interacting with countries, and of systems for audit and follow-up on allegations of corruption. These systems have been relatively weak until recently in many agencies, as numerous alleged cases of corruption concerning aid projects attest (Uganda: Bujagali Dam; Kenya: Kutip transportation project; Lesotho: water project, to name just a few examples). A number of donors have strengthened their systems in recent years. We may assume that corruption risks associated with aid projects are declining as a result of these efforts, but no evidence of the degree of such a decline (if any) is available.

Kenny (2006) takes a specific look at the developmental impact of corruption in the infrastructure sector. He emphasises that the development impact of corruption depends more strongly on the selection of projects, quality of inputs used, and subsequent maintenance, and only to a lesser extent on the bribe paid in the context of a contract. Based on (anonymous) interviews with contractors with substantial experience in sub-Saharan Africa, Hobbs (2005) provides a detailed description of how corruption has occurred in World Bank contracts. He claims that: (i) bribes are standard in procurement contracts (at a rate of 10% to 15% of the contract value), and (ii) World Bank procurement procedures and audits were unable to detect these standard forms of corruption.¹ His report also indicates that, relative to the large number of contracts annually handled by the World Bank (40,000), only a very small share had traditionally been subjected to in-depth auditing (26 in 1999). In 2001, the Bank created the INT, which has since led to a higher number of investigations, but staff numbers and costs of investigations are limiting factors. Hobbs concludes that full micro-level control of projects would be prohibitively expensive; hence, focusing on strengthening country systems in principle is useful.

⁹ See http://www.theglobalfund.org/en/media_center/press/pr_060602b.asp.

4 Empirical studies of corruption and budget support

There are few quantitative studies that disaggregate aid into subcategories. Even fewer of these test how governance affects the effectiveness of the various aid modalities. No study has yet addressed the question of how corruption affects the developmental impact of budget and project support. Initial studies on the evaluation of budget support have not addressed issues of corruption in depth (IDD and Associates, 2006). One reason for this is that data disaggregated by aid modality have been scarce or not very reliable. This gap is beginning to be filled, including by the results of the Paris Declaration Baseline Survey (OECD, 2007b), and by the results of the three rounds of the Survey of Budget Support in Africa (Strategic Partnership with Africa, 2007).

There are a few econometric cross-country studies on the relationship between governance, aid and growth which have used data disaggregated by aid modality (drawn from the OECD's Creditor Reporting System (CRS)). Furthermore, there are a number of case studies where budget support to individual countries has been examined, and these provide an informative yet scattered picture. Several donor evaluation reports, including the Joint Evaluation of General Budget Support 1994–2004 (IDD and Associates, 2006), to varying degrees address the question of corruption. Below, we review the findings from these three types of studies in turn. As set out above, we currently know very little from empirical research about corruption and budget support. Further studies into this nexus should be conducted.

4.1 Cross-country studies

There are two econometric cross-country studies of the effectiveness of different aid modalities under different governance conditions (of which we are aware). Cordella and Dell'Araccia (2003) expand on the analysis of Burnside and Dollar (2000) by distinguishing between programme aid (which in addition to budget support includes import support and debt relief) and project aid flows. The policy measure used by this study is a composite index of inflation, budget surplus and openness. It is thus a measure of macroeconomic governance. The study finds that the growth impact of budget support is more sensitive to the policy environment than project support. It finds that budget support has a relatively greater impact on growth in countries with good macroeconomic policies, whereas project support is more beneficial for growth in countries with poor macroeconomic policies. Aid disaggregation is based on OECD/CRS data, and the years covered are 1974 to 1993 – i.e. before more current generation forms of budget support were used.

Ouattara and Strobl (2006) criticise Cordella and Dell'Araccia (2003) for using data on aid commitments rather than actual disbursements of aid. Basing their aid modalities data also on the OECD's CRS, but calculating shares in disbursement from these and using a time series reaching to 2001 and running a similar analysis, Ouattara and Strobl find that project support on average affects growth positively, whereas programme support has no effect or a negative effect. Furthermore, in their analysis, the effect of the various aid modalities does not depend on partner country governance (again measured by an index of macroeconomic conditions). In sum, the findings from the two studies are conflicting; the implications for the wider debate about governance are uncertain.

No econometric study has to date addressed the question of how corruption affects the relative developmental impact of budget and project support. More studies – drawing on better underlying data for aid modalities used – should be conducted as more and better data become available.

4.2 Case studies and evaluations

The case studies and evaluations of budget support that exist, to the extent that they address the issue of corruption, tend to focus on the impact of budget support on corruption more than the effect of corruption on developmental impact.

A set of evaluation studies performed by USAID (2005b) in five countries suggests that corruption may have been a factor in country differences in the success of budget support. In particular, the Malawi evaluation points to serious problems with budget support, and relates these in part to the problem of political corruption. It further argues that there has been "an unwillingness by the government to deal decisively with corruption" (USAID, 2004b). By contrast, "[d]onors interviewed for the Tanzania study do not believe that the increased use of GBS has been associated with more corruption. However, corruption may become more apparent as financial systems are strengthened, regardless of whether more funds are actually diverted" (USAID, 2005b).

Devarajan and Shah (2006) consider budget support to South Asia. They conclude that corruption and budget support are a concern with regard to politics in donor countries, but not to aid effectiveness as such:

"The general problem here is one of perceptions. Of course, providing budget support to a country that Transparency International has labelled the most corrupt in the World [Bangladesh] "looks bad". But if the decision has already been made to transfer some money to Bangladesh, then the question is, what type of instrument will produce the best results? As we have argued above, by focusing on the whole of the public sector and providing incentives for economy-wide reform, budget support operations have a better chance of addressing the very governance problems that plague a country. [...] Moving the debate from these perceptions to the reality of results on the ground is the biggest remaining challenge for budget support operations in South Asia."

Devarajan and Shah stress that "[i]n those instances where politics discouraged early adoption of reforms, analytical work done as a part of a knowledge partnership underlying potential budget support has facilitated domestic debate and the creation of a climate of reform." They argue that weak governance is therefore not a reason not to give budget support. They appear, however, to contradict this conclusion by the observation that "[m]any of the conditions for making budget support operations feasible in Punjab (strong government commitment to reform, relatively good financial management practices, monitoring and evaluation capacity) do not exist in Balochistan."

White and Dijkstra (2003) perform an analysis of Swedish programme aid to eight different countries plus Dutch/World Bank programme aid to Ghana.¹⁰ In terms of the impact of programme aid on reform, they conclude that "domestic political considerations are the prime factor in determining economic and political reform: most countries have initiated reform without donors, and have carried out some measure of reform not required by them, while ignoring others that have been required." They thus find support for an "emerging consensus that money can't buy policy". On Bangladesh, they take a view different from Devarajan and Shah (2006), noting that "donors have been pushing for the usual reform agenda in Bangladesh during the 1990s. Official compliance with donor demands has been strong, but actual implementation has lagged far behind." Interestingly, however, they note that "bilateral donors also seem to have some influence on the dialogue without actually giving programme aid."

¹⁰ In their book, 'programme aid' is defined as import support, debt relief (collectively also known as balance of payment support) and budget support.

In a study of budget support to Tanzania, Lawson et al. (2006) argue that macroeconomic management and PFM have been improved. They find that “[f]undamental progress has been driven by internal political commitment to change in these areas. But it could have been considerably more difficult if there had not been donor budget funding, together with the associated dialogue and other inputs – or if such funding had been channelled through other aid modalities.” There are however, “few signs of improved efficiency of public spending”, and the challenge function in the budget process remains weak, mainly for political reasons. The study concludes that an impact of budget support on accountability is not automatic; it can at most facilitate change induced by domestic actors. Williamson (2006) mirrors this sentiment in a study of Tanzania and Uganda, arguing that “it is attractive to believe that [general budget support] can cause improvements in PFM systems, but [general budget support] only supports and facilitates these improvements, political support and technical leadership are more important.”

A country that is of particular interest with regard to new aid modalities and corruption is Mozambique. The issues and dynamics are set out in Box 2.

The Joint Evaluation of General Budget Support 1994–2004 includes a section on corruption in its synthesis report and in each of the seven country reports. This evaluation has, however, devoted less attention to the subject of corruption than to other issues related to budget support, and hence deals with corruption only in a summary way. There is little information in the evaluation on how corruption may have affected the development effectiveness of budget support, but more on how budget support may have affected governance reform and corruption. The results on this appear to be rather mixed. On the effectiveness of aid modalities in the context of corruption, the synthesis report concludes that “[t]here was no clear evidence that budget support funds were, in practice, more affected by corruption than other forms of aid” (IDD and Associates, 2006). However, given the focus of the report, this is more of a suggestion than an empirically well evidenced statement. The evaluation concludes that it does not make sense to think of systematic thresholds which countries have to meet in order to be eligible for GBS, either in terms of corruption or with regard to other issues. However, it does regard a relationship of trust between donors and development partners as essential.

The country studies of Mozambique and Vietnam suggest that project support is more easily misused than budget support, or that there is no more or less leakage from budget support than from projects support, based on donor perceptions and ‘reasonable’ beliefs (Batley et al., 2006; Bartholomew et al., 2006). The Malawi country study, by contrast, sees corruption as more of a problem for the effectiveness of budget support. It notes that “over-optimism concerning progress on issues of political governance and the nature of patronage politics combined with the fluidity of Malawian politics, has been a major problem for aid management. This may have been more serious for PGBS [partnership general budget support] aid than for project support because of PGBS’ direct reliance on partner governance competence” (Claussen et al., 2006). The Uganda country study suggests that “budget support may be more vulnerable than other forms of aid when the quality of the relationship between government and IP [international partners] deteriorates and the IP wishes to distance itself from the regime” (Lister et al., 2006), thus speaking to the concern about the greater reputational risk for donors that is associated with budget support.

Box 2: Budget support and corruption in Mozambique

Mozambique is of particular interest because it has received large amounts of aid since the 1990s and has “become a model and a testing ground for so called ‘new aid modalities’” (de Renzio and Hanlon, 2007), with 18 donors by now participating in budget support, and because there has been an intense debate with respect to aid and corruption. As Hanlon (2004b) and others have argued, corruption was relatively low in the 1970s in Mozambique. Since the end of the civil war in 1992, Mozambique has received large amounts of aid, first under the paradigm of ‘structural adjustment’ and since the late 1990s under the paradigm of ‘poverty reduction’. During this period, corruption has spread and this process continues. By TI, Mozambique was rated 3.5 in 1999 and 2.8 in 2006, reflecting an increase in corruption even during the period when donors began to focus on combating corruption more intensively (after a major banking scandal that was rooted in corrupt deals in 2000/2001). A qualitative study by USAID confirmed the picture of high levels of corruption and found little commitment by the ruling elite to combat the situation (USAID, 2005a).

Macamo (2006) has analysed the relationship between programme aid and political governance in Mozambique. He argues that programme aid (including budget support) has had several flaws and unintended consequences – especially strengthening the dominant party. Macamo furthermore points out that, while programme aid/budget support in principle creates an enabling condition for greater domestic accountability in terms of financial flows, in practice the policy dialogue related to budget support has tended to create a close government–donor relationship, which has been detrimental to the policy dialogue between government and society. Also, programme aid as it has been provided has continued to set up systems (such as sector working groups) that have operated parallel to government. Nonetheless, Macamo argues that it has the potential to bring substantial improvements over a situation where all aid is given as project aid.

A USAID (2004a) evaluation points to similar problems in improving accountability: “in Mozambique, the press, parliament, and civil society are no match for the government – they have a difficult time improving accountability or reducing corruption ... GBS cash transfers are at high risk in such an environment and may not be effective.”

De Renzio and Hanlon (2007) argue that, thus far, donors have accepted the continuation of significant levels of corruption alongside the provision of high levels of aid, and of budget support in particular. Several studies on governance and corruption have been commissioned, but with little in-depth follow-up. At the same time, the government has not openly resisted the donors’ governance agenda, but has sought to agree in principle yet without undertaking changes in earnest.

In a recent World Bank review of budget support, NORAD makes the following case about providing budget support to Mozambique (World Bank, 2006a): “In the international debate, donors were criticised by some (including Hanlon, 2004b) for not adequately addressing the issue of corruption, allegedly because they wanted to maintain the donor ‘success story’ of Mozambique. Under the previous agreement with the Mozambican government (2001–2003), Norway, like other donors, decided to disburse its programmed budget support, despite the banking crisis. The possibility of putting pressure on the Mozambican government by holding back budget support was, however, discussed in the donor group, with Norway and Sweden as the main advocates for this view. In April 2001, when the Banco Austral crashed, the budget support providers collectively decided to keep back disbursements for a period. In the Consultative Group meeting of October 2001, the Mozambican government committed itself to four follow-up actions related to the banking crisis: (1) prosecute wrongdoing in the financial sector to the full extent of the law, (2) make purposive and equitable efforts to recover outstanding debts, (3) divest the government’s interests in banks, and (4) strengthen banking supervision. The donor community regarded these commitments as a satisfactory response to the banking crisis, and donor funds were released as planned.”

In terms of reform, the evaluation emphasises the positive effect budget support has had on dialogue and engagement (on sector policies, as well as governance, including PFM and corruption issues), and on technical aspects of economic management. In particular, the synthesis report points out that budget support “plays a valuable role in strengthening public financial management” which is “a means of limiting the scope of corruption” (IDD and Associates, 2006). The Uganda country study points out, however, that budget support “provides an avenue of communication, and there is progress at technical levels and where there is a strong constituency for reform on the [government] side... but budget support cannot ‘buy reforms’ or ensure government behaviour that meets [donor] standards of democracy when the governing regime feels that its fundamental interests and ultimate survival are at stake” (Lister et al., 2006). The Uganda study also states that, technical progress notwithstanding, some donors have been disappointed at the lack of progress in reducing corruption.

The lack of government commitment to reform is commented on in several country studies. The Mozambique report states that, while there has been progress in formal statements of intent, corruption remains an area of concern (Batley et al., 2006). Similarly, the Burkina Faso report points to calls from donors for more tangible and concrete government commitment in fighting corruption (Lanser et al., 2006). On the effect of budget support on domestic accountability, several reports suggest that there may be little effect. The Nicaragua study sees little evidence of more inclusive dialogue or a transparent and shared performance assessment system as a result of budget support (Gosparini et al., 2006). The Mozambique study states that the parliament’s capacity to exercise its role is weak, as is the political process. It argues that the deeper factors underlying these matters are “largely beyond the influence of donors and [budget support]” (Batley et al., 2006). The Uganda study similarly calls for “realism about the speed and depth of change that can be brought about through what are essentially technocratic means”, and argues that, though dialogue may strengthen participation and accountability in government processes, “donor intervention in sector and budget processes can drown out domestic voices, whether of Parliament or civil society ... and distract from the need to provide domestic stakeholders with information that will enable them to hold the state to account” (Lister et al., 2006).

The evaluation notes that donors that provide GBS are often prominently engaged in anti-corruption activities (although, as for any other purported effects, the evaluation grapples with the issue of attribution). The Rwanda country report, for instance, states that “it is not clear whether [donors’] access to dialogue over political governance stems from [budget support] or from an established relationship of trust at a high level” (Purcell et al., 2006). As set out above, as budget support exposes donors to greater reputational risks, it is likely to be an important part of their motivation – but this may not necessarily have the desired results. The evaluation argues – in line with the findings of Kolstad et al (2008) – that the anti-corruption activities that donors have supported may have been ineffective. Overall, the report sees support for PFM reforms and capacity building as the most promising avenue for mitigating risks and ultimately also for reducing opportunities for public sector corruption.

Overall, existing empirical research and evaluations provide a mixed and inconclusive picture of the implications of corruption for the choice of aid modalities. No econometric study has to date tested the impact of corruption on the relative effectiveness of budget support. Studies of this kind should receive priority as better data on disaggregated aid become available. Country case studies and evaluations differ on how corruption affects the relative effectiveness of budget and project support. The Joint Evaluation is a case in point, where the synthesis report does not see budget support funds as more affected by corruption; some individual country reports (e.g. Malawi) suggest the opposite. What a number of case studies and evaluations do suggest is that budget support may have enhanced dialogue and engagement, and had some effect on technical aspects of economic management, in particular in the area of PFM. At the same time, several studies are sceptical that budget support can ‘buy reform’ not in the interests of ruling elites, and the effect on domestic accountability is also questioned. Given that questions about budget support and corruption are of considerable policy

relevance for donors, it would seem worthwhile investigating these questions further as part of future budget support evaluations and/or country research and evaluations.

5 Summary

Budget support is preferable to other aid modalities if it more effectively promotes development and/or institutional reform in partner countries. This U4 Issue has reviewed the information that analytical arguments and empirical studies provide on: (i) the prevalence of corruption in relation to various aid modalities, and the degrees to which corruption distorts the developmental impact of different aid modalities; and (ii) whether aid modalities affect the governance environment and corruption in a country differently. In summary, the conclusions are:

1. From a theoretical perspective, **for countries where aid is fully fungible, the choice of aid modality does not affect aid allocation nor accountability.** If budget support saves on transaction costs, it is therefore a better choice than project support, regardless of the level of corruption.
2. **Where aid is imperfectly fungible, donors have some more control over aid allocation with project than with budget support.** Where this is the case, and **corruption is high**, there are three reasons for not choosing budget support as an aid modality: the reputational risk (and the increased likelihood that budget support would have to be suspended at some point), the higher risk of budget allocation decisions being driven by rent-seeking motives, and the fact that making budget support available regardless of performance reduces its incentive character. However, there is little clear guidance available with regard to cut-off points (i.e. at which level of corruption the risks outweigh the benefits).
3. **The challenge facing donors is to draw a line between countries that are considered ‘too corrupt’ and those that have ‘acceptable’ levels of corruption.** For most donors, the overall governance situation – including respect for human rights, civil and political freedom, commitment to development – will be decisive, rather than corruption on its own.¹¹ Most developing countries fall into the bottom third of the most widely used governance indices (WBI/KKZ and TI/CPI); the level of corruption is not the only dimension that matters in the decision matrix (so its weighting relative to other factors is also an issue). Developing guidance is important; such guidance could be reviewed as further/better evidence becomes available.
4. Available evidence suggests that the corrupt misuse of aid (and of budget) funds is a risk when project aid and budget support are being used. Thus, **when project aid is being used as a preferred modality in highly corrupt environments, sound but sensible corruption safeguards will certainly be necessary** (e.g. ensuring that results are being achieved; introducing effective controls without over-bureaucratising the aid disbursed through projects).
5. **The claim that budget support is likely to increase domestic accountability needs to be revisited.** The effect on domestic accountability appears to depend on the strength of the government compared with the groups and institutions that hold it to account. **Budget support seems most problematic in countries which are highly corrupt and have an oppressive**

¹¹ The MCA uses level of corruption as an overriding criterion, i.e. a country is ineligible for MCA funds if it falls into the bottom half with respect to corruption among its ‘peer group’ (defined in terms of income level). However, the MCA is designed as an ‘additional’ amount of aid, or an ‘incentive tranche’ (in EC jargon), and thus the mechanisms it uses could not be transferred one-to-one to aid in general.

government – in such cases, there is the greatest risk that allocation decisions are driven by rent-seeking motives, and that budget support enhances the power of the incumbent government in ways that may reduce rather than enhance domestic accountability.

6. Budget support increases government ownership over aid resources. At the same time, it can increase external accountability with regard to the budget as a whole. **Whether greater government ownership over aid leads to better overall accountability and less misuse of funds appears to depend on the domestic political economy landscape** and the strength of the various components of **the domestic accountability system** (vertical, horizontal, societal and managerial) as well as on **the political economy of the aid relationship**.
7. Donors providing budget support may have a greater incentive to support the reform of country PFM systems and of wider country governance (because these are essential to ensure that their aid will be used well, and because of the greater reputational risk to donors). Recipient countries may have an incentive to ‘show’ effort (to ensure the receipt of budget support), but not necessarily to follow through. Available evidence suggests that **budget support has been associated with progress on technical issues**, such as PFM reform. At the same time, **it seems unlikely that budget support can ‘buy reform’ not in the interests of domestic actors**. Further progress on reforms may be related to the balance of effects on domestic accountability. This underscores the points made in Kolstad et al (2008), about the importance of analysing interests and informal interactions rather than just formal institutions.
8. **The increasing emphasis in the donor community on budget support has not been matched by similar efforts to evaluate empirically the impact and effectiveness of this type of aid**. In particular, there are no empirical studies that systematically and thoroughly evaluate the implications of corruption for the effectiveness of different aid modalities. Further research is needed to address these issues systematically, which would produce more information on ‘cut-off points’, and the relative importance of corruption compared with other aspects of governance.

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Abstract

The introduction of 'new' aid modalities – and in particular general budget support – has increased the interest in the relationship between corruption and aid modalities. This U4 Issue reviews the information that empirical studies provide on the prevalence of corruption in relation to various aid modalities, the degrees to which corruption distorts the developmental impact of different aid modalities, and whether aid modalities affect the governance environment and corruption in a country differently. It concludes that the choice of aid modality does not seem to affect aid allocation nor accountability in countries with relatively low levels of aid, regardless of the level of corruption. With high aid dependency, however, donors have some more control over aid allocation with project than with budget support. Where this is the case, and corruption is high, there are strong reasons for not choosing budget support as an aid modality.