



Direct budget support and corruption

Ivar Kolstad

U4 ISSUE 1:2005

U4 (www.U4.no) is a web-based resource centre for donor practitioners who wish to effectively address corruption challenges in their work. We offer focused research products, online and in-country training, a helpdesk service and a rich array of online resources. Our aim is to facilitate coordination among donor agencies and promote context-appropriate programming choices.

The centre is operated by the Chr. Michelsen Institute (CMI), in association with Transparency International. CMI is a private social science research foundation working on issues of development and human rights, located in Bergen, Norway.

U4 Partner Agencies: DFID (UK), Norad (Norway), Sida (Sweden), Gtz (Germany), Cida (Canada), and the Netherlands Ministry of Foreign Affairs.

All views expressed in this issue paper are those of the author(s), and do not necessarily reflect the opinions of the U4 Partner Agencies.

Copyright 2005 – U4 Anti-Corruption Resource Centre

DIRECT BUDGET SUPPORT AND CORRUPTION

Written for U4 by Ivar Kolstad - CMI

How does corruption affect the appropriateness and design of budget support? The aim of this issue paper is to compare the effectiveness of budget support versus that of other aid modalities - in particular project support - in partner countries characterized by corruption. It discusses how corruption affects or mediates the impact of budget support on developmental outcomes such as growth and poverty, but also the impact of budget support on institutional reform.

CONTENTS

Introduction - page 3

1. Definitions - page 4
2. The pros and cons of direct budget support - page 4
3. The effect of direct budget support on corruption 6
4. Conditionality and sequencing - page 7
5. Rent-seeking in fractionalized societies- page 10
6. Implications for fiduciary risk assessments - page 10
7. Relevant links and resources - page 12

INTRODUCTION

Budget support is normally policy-based aid. As illustrated in the below figure, the issue paper is structured around this observation.



In addition, the paper outlines how budget support might in itself influence the level of corruption in partner countries.

The text draws on available studies and evaluations addressing the question of corruption and budget support. As available evidence on this is limited, there is some extrapolation from studies of related issues, and some conclusions must be regarded as tentative and preliminary.

The rise of budget support and fiduciary risk assessments

Budget support is on the rise. Though general budget support accounted for only a small part of total official development assistance in the 1990s, recently several donors have signalled a commitment to increasing the share of aid given as budget support. For instance, the World Bank spent about 50% of its total assistance on budget support in 2002, up from about 10% in the 1980s. Similarly, DFID spends about 15% of its current budget on budget support, a proportion that is to increase in coming years.

Budget support requires a well-functioning public financial management (PFM) system to be effective. For this reason, the increased emphasis on budget support has led to an interest among donors in developing and improving tools for assessing fiduciary risk in partner country PFM systems. Corruption is one type of fiduciary risk which is particularly relevant for budget support. And the implications of corruption for budget support has been a hot topic since DFID recently rejected budget support to Bangladesh due to its high level of corruption.

What you will not find in this issue paper

This issue paper focuses on corruption-related issues only. It therefore does not contain a complete account of all the arguments, questions, and debates, that concern the use of budget support. Nor does the paper go into detail on issues that are covered elsewhere on the U4 anti-corruption resource centre web site. Certain areas where corruption may play a role, but where there is no evidence available, are also given limited attention. In sum, some of the issues covered to a lesser degree are:

- The political economy of budget processes: For a more in-depth discussion of this, please consult the separate U4 issue paper on the budget process and corruption on www.u4.no
- The impact of budget support on tax collection effort – see U4 issue paper on Revenue administration and corruption at www.u4.no
- PFM technical assistance/capacity building: See rather “Best Practice in Capacity Building in Public Finance Management in Africa” at www.cmi.no/publications/2002/rep/r2002-16.pdf
- Indices of corruption: See rather “Estimating corruption: Comments on available data” at www.u4.no/document/showdoc.cfm?id=88

The issue paper is based on information that is currently available. As the evidence on corruption and budget support is limited, patchy, scattered and often anecdotal, some of the conclusions are tentative and preliminary, and should be reviewed as new evidence becomes available. In particular, a multi-donor evaluation of budget support currently underway, may offer additional information. As the reports from this evaluation are due September 2005 (country case studies) and December 2005 (final report), their conclusions are not included in this paper. According to informed sources, however, corruption is not given much attention in these evaluations.

1. DEFINITIONS

Budget support

Budget support is aid transferred to a partner government's National Treasury, to be managed by means of the beneficiary's budgetary procedures. In other words, one can contrast budget support with aid transferred to fund predetermined projects, i.e. project support. Budget support is usually policy-based aid (with conditions attached), and coordinated among several donors (basket funding). Budget support is a sub-category of programme aid, which also includes balance of payments support (i.e. import support and debt relief).

There are various forms of budget support. General budget support is disbursed in support of the general national budget, and often comes with conditions on overall policies. Sector budget support is channelled towards specific sectors, such as education or health, and incorporates more sector-specific concerns. Budget support is also sometimes categorized according to the conditions attached. Poverty reduction budget support hence denoted budget support whose conditions and dialogue focus on poverty reduction strategies.

Corruption

Corruption is often defined as the misuse of public office (or power) for private gain. Corruption is commonly categorized into political and petty corruption. Political corruption (or grand corruption) takes place at the high levels of the political system, when politicians and state agents entitled to make and enforce the laws in the

name of the people, are using this authority to sustain their power, status and wealth. Petty corruption (or bureaucratic corruption) is the everyday corruption that takes place at the implementation end of politics, where public officials meet the public. Petty corruption is bribery in connection with the implementation of existing laws, rules and regulations, and thus different from "grand" or political corruption. A concept related to that of corruption is patronage, which implies acting in the interests of a certain group of people, in order to secure their political support or the reciprocation of favours in other ways.

Corruption can be seen as a form of rent seeking, which can be defined as using productive resources to gain an advantage in dividing up the benefits of economic activity. Corruption is also a type of fiduciary risk, which in the present context is the risk that aid funds are not used for the intended purposes, do not achieve value for money, and/or are not properly accounted for.

2. THE PROS AND CONS OF DIRECT BUDGET SUPPORT

Corruption affects balance of arguments for and against budget support

A number of arguments have been advanced for providing budget support. The validity of some of these arguments are affected by the presence or possibility of corruption. This section shows how corruption can weaken some of the common rationales given for budget support. In doing so, the section also introduces some key concepts and ideas, to be explored in more detail on other parts of these pages.

The following is a list of standard arguments for providing budget support. The arguments significantly affected by corruption, are highlighted as links. By clicking on these links, you can find out how corruption affects each of these arguments:

- [Budget support increases ownership](#)
- [Budget support increases accountability](#)
- [Budget support facilitates dialogue](#)
- [Aid is fungible, and project support costly](#)
- [Budget support facilitates donor coordination and harmonization](#)
- [Budget support builds institutional capacity and improves allocative efficiency in partner countries](#)
- [Budget support provides predictable development funding](#)
- [Budget support is flexible and quickly disbursable](#)

There are also arguments against budget support. For a summary, see OECD/DAC: "Good Practice Note on the Provision of Budgetary Support - A Public Financial Management Prospective" at www.capacity.undp.org/index.cfm?module=Library&page=Document&DocumentID=5102.

Budget support increases ownership - and discretion

One of the defining characteristics of budget support, is that funds are to be allocated through the budgetary procedures of the partner country. Budget support thus increases ownership of development policies by the partner country. Ownership can be important in itself, and in enhancing the effectiveness or sustainability of development efforts. However, in terms of corruption, increased ownership is problematic in two ways.

Firstly, the other side of the ownership coin, is increased discretion for government officials. We know from basic models of corruption that increased discretion for potentially corrupt agents, increases corrupt activities. In simple terms, the freer agents are to make decisions, the higher payoffs can be extracted from those affected by the decisions. Budget support increases the discretion of government officials in allocating funds - potentially increasing corruption in countries where control and sanctions of government officials are weak.

Secondly, we need to look at whose ownership is increased. Budget support basically promotes ownership by the central government of a country. Central governments can be more or less democratically elected, and more or less vulnerable to electoral competition. To the extent that budget support allows a government to monopolize allocative decisions over public funds, this can lead to an increase in corruption.

Budget support increases accountability - or does it?

Accountability reduces corruption. If someone can detect and sanction the misuse of public funds, it becomes less attractive. It is often argued that budget support makes a government more accountable to its people. Several mechanisms through which this would work have been suggested:

- budget support underscores the budget's role as the statement and tool of government policy
- budget support stresses the idea that the government is responsible for allocative decisions
- budget support brings aid on budget, promoting the contest between different expenditure categories, and leading to a more effective budget process

In some settings, however, these mechanisms may be insufficient for increased accountability. In countries where parliament or the people have little actual influence on allocative decisions, and do not have the power to sanction government misconduct, the above mechanisms will not have much bite. An evaluation of budget support to Mozambique, concludes that "the press, parliament, and civil society are no match for the government - they have a difficult

time improving accountability or reducing corruption" - a statement which extends to other African countries with centralistic political systems. In countries where other institutions are largely unable to hold a government to account, budget support will in itself have little effect on accountability. One can also argue that by filling central government coffers, budget support can in fact strengthen the power-hold of the central government, making it less accountable, a point explored here.

Budget support facilitates dialogue - or cheap talk?

Budget support involves a process of dialogue between donor and partner countries, to establish priorities and expectations related to development policies. Budget support is usually given with conditions attached. Donor - partner dialogue is important in dispelling uncertainty on goals and expectations on either side, and serves to coordinate the efforts of donors and partner governments. At the end of the day, however, whether what has been agreed through dialogue is actually implemented, is a question of whether it is in the interest of the parties involved to indeed implement. Dialogue is therefore little more than cheap talk, useful to clarify ends and expectations, and to coordinate efforts - but in itself insufficient to produce actions that are not in the interest of partner country governments.

In countries with corrupt governments dialogue on anti-corruption measures is unlikely to result in concrete action if the rents available to government officials are thereby reduced. Recent experiences from Uganda suggests that corrupt high level officials will attempt to undermine effective anti-corruption reform, for instance by cutting funding to anti-corruption agencies. The effect of dialogue in corrupt countries is related to the effectiveness of conditionality, an issue explored further here.

Aid is fungible, and project support costly - but sometimes worth the costs?

If aid is completely fungible, it will result in the same set of development activities, whether given as project or as budget support. And if project support incurs greater transaction costs than budget support, through the formulation, implementation, and follow-up of a number of fragmented projects, perfect fungibility implies that aid should be given as budget support.

Fungibility means that a partner country government can reallocate aid given to a specific project or sector, by simply reducing its own expenditure on that project or sector. In other words, if a donor gives USD 1 billion to the education sector, a partner country government can reallocate that amount to the health sector by decreasing its own spending on education by USD 1 billion, and increasing its own spending on health comparably. Aid can be perfectly fungible, as in this example, or it can be infungible, if given to activities that a government would not support in the absence of donor funding. The extent to which aid is fungible depends, inter alia, on the ratio of the government's own revenue to aid. For very aid dependent countries, where aid constitutes a large part of the public budget, there will be less opportunities for transferring aid across sectors in this way.

Though aid is fungible, and project support costly, it can in certain cases be in the interest of donor countries to provide project sup-

port to corrupt countries. Compare two partner countries, where country A has a corrupt government and country B a clean government:

If aid is fungible, both countries will reallocate aid funds according to its objectives. However, while the government of country A reallocates funds to line its own pockets, the government of country B reallocates to meet other ends, for instance improving health or education. Donors may take a dimmer view of the reallocation in country A than in country B.

If aid is less than perfectly fungible, donors might then prefer to incur the higher transaction costs of project support in country A, to avoid the appropriation of a large part of the resources by corrupt officials. Even if aid is (somewhat) fungible, and project aid costly, this might still be the preferred form of aid in countries with a corrupt government.

3. THE EFFECT OF DIRECT BUDGET SUPPORT ON CORRUPTION

Corruption moderates the effect of budget support on growth and poverty

Corruption affects which aid modality is more effective in promoting growth and alleviating poverty. This section reviews the available studies and evaluations bearing on this issue. The focus is on the relative impact of general budget support versus that of project support, though sector budget support is discussed in the final subsection.

In summary, available studies indicate that:

- The level of corruption matters: Budget support not advisable in highly corrupt countries
- Type of corruption may matter: Political corruption may make budget support unsuitable
- Distribution of corruption matters: Targeting aid towards islands of integrity

Fiduciary risk assessments in relation to budget support should therefore include all these elements in partner countries where corruption may be a problem – see part 6.

Level of corruption matters: Budget support not advisable in highly corrupt countries

Aid promotes growth where institutions are good. This is the result of a study by World Bank economists Burnside and Dollar. Though their conclusion has not gone unchallenged, it remains a much cited one in the development debate. The Burnside and Dollar study does not, however, estimate the impact on growth of different aid modalities.

Budget support works better where institutions are good, project support where institutions are bad. In a study by two IMF econo-

mists, the analysis of Burnside and Dollar is rerun, with total aid being divided into budget and project support. The result is that budget support has a greater impact on growth in countries with good institutions, whereas project support is more beneficial for growth in countries with bad institutions. According to this study, whether to use budget or project support is a question of the institutional environment. The measure of institutions used, however, is a macroeconomic one, and includes inflation, budget surplus, and openness. The results therefore do not directly tell us which aid modality works best in a corrupt versus non-corrupt environment.

However, corrupt countries have less productive and less pro-poor public spending. Several studies show that corrupt countries spend less on education and health, and more on the military. As human capital formation is conducive to growth, whereas military spending may be detrimental thereto, this may partly explain why corrupt countries have lower rates of growth. Similarly, spending on education and health is directly relevant for poverty reduction, and public resources therefore have less of an impact on poverty in corrupt countries. The implication for budget support is that if aid is less than perfectly fungible, budget support has a lower impact on growth and poverty reduction in corrupt countries.

Type of corruption may matter: Political corruption may make budget support unsuitable

Petty corruption decreases the effectiveness of any type of aid. Where petty corruption is widespread, it functions as a tax on a large range of activities, including activities financed by aid. Though budget and project support fund different activities, it is hard to say whether there is some systematic difference between the activities funded, which makes one form of aid more susceptible to petty corruption. Without additional information, is it therefore hard to assess whether petty corruption favours budget or project support.

Political corruption may be more detrimental to budget support, than to project support. If those in power of the public purse are corrupt, topping up that purse will lead to funds being diverted into private hands. And budget support amounts to topping up the public purse. With project support, funds are tied to a specific activity, and cannot always be as directly appropriated by a corrupt political elite. This does not mean that projects are immune to corruption in this sense, but there is at least a potential for safeguarding funds when providing project support.

That political corruption is adverse to budget support, is also suggested by USAID evaluations of budget support to Tanzania, Mozambique, and Malawi. While the evaluations argue that budget support to Tanzania and Mozambique has worked reasonably well, budget support to Malawi has not. Since Malawi has approximately the same score as the other two countries on the Transparency International Corruption Perceptions Index, corruption as such does not seem to be the reason for the different effect of budget support.

The Malawi evaluation suggests, however, that a high degree of political corruption is one cause of the bad performance of budget support in Malawi. More evidence is needed to determine whether this is in fact what separates Malawi from Tanzania and Mozambique in this respect. Nevertheless, that political corruption has an

adverse effect on budget support, can at least be used as a working hypothesis.

Distribution of corruption matters: Targeting aid towards islands of integrity

In some cases, there may be relatively “clean” areas in an otherwise corrupt set of public institutions. Different ministries, departments, and public institutions, face different incentives for corrupt activities.

By the nature of their activities, some ministries are more subject to public scrutiny than others. For instance, health or education may entail more transparent activities than defence. Some ministries and institutions also serve politically potent stakeholders, and would suffer greater consequences of misconduct (tapping the wages of powerful union members is one example). When incentives differ across the political-bureaucratic system, and the system has certain structural properties, different parts of the system can develop quite different views and practices in terms of corruption.

There is thus a possibility that islands of integrity may develop in an otherwise corrupt institutional setting.

Where islands of integrity exist, sector budget support can be channelled towards them. To use sector budget support in this way, one must map the distribution or variation of corruption across the political system. Again, this requires that funds are less than perfectly fungible, so that they cannot be completely appropriated by other parts of the political system through reallocation. The idea of targeting sector budget support in this way, is related to the more general notion that if certain parts of the public financial management system of a partner country function, aid should be channelled through them.

A word of caution should be expressed on islands of integrity and sector budget support. Firstly, studies of corruption in hierarchies show that where top officials are corrupt, lower level officials are also corrupt. This suggests that if the top ranks of government are corrupt, clean areas in the other and lower parts of government are unlikely to be found. In certain cases, looking for islands of integrity would therefore be a waste of time and resources. Moreover, even if islands of integrity do exist, one should be careful to act in a way that supports their existence. Budget support alters the incentives of public officials, potentially increasing the benefits of corruption, and may therefore alter the behaviour of supposedly clean segments of the political system.

4. CONDITIONALITY AND SEQUENCING

Corruption makes conditionality ineffective, and sequencing important

Efficient use of budget support requires a good institutional environment. This applies in terms of general macro-economic governance, but specifically as regards the quality of the PFM system. Budget support commonly takes the form of policy-based aid, where dialogue and conditions are attached, with a view to improving the institutions of a partner country. Corruption intro-

duces added considerations and challenges, to the question of how to spur institutional reform in partner countries. This section explores how corruption affects the impact of conditionality, and the degree and sequencing of PFM reform:

- Conditionality ineffective in corrupt countries
- Sequencing PFM reform and budget support to avoid increased corruption
- An example of sequencing problems: PFM reform in Cambodia
- Conditionality ineffective in corrupt countries

Money cannot buy policy. A number of studies conclude that conditions and dialogue attached to programme support, have failed to produce the intended reform in partner countries. Though partner countries assent to reforms, they do not implement them, and donors fail to punish non-implementation by withholding aid. Thus, there is by now an informed consensus that conditionality is ineffective in delivering reform.

Exceptions to this rule have been noted, however. Where there is domestic support for reform, but the support is hard to mobilize (by some called a collective choice dilemma), donor pressure might produce the momentum needed to bring about reform. In other words, where reform is in the domestic political balance, donors might tip the scales in favour of reform.

In countries where corruption is sufficiently entrenched and widespread, donor pressure is unlikely to have this kind of effect. If a large part of the political establishment derives significant benefits from rent-seeking, or key segments of the population benefit from patronage, mobilizing domestic support for dismantling the current state of affairs will be unrealistic.

Conditionality is therefore likely to be ineffective in highly corrupt countries. A worst case scenario is that a country implements only conditions that serve to strengthen the position of the ruling elite. These arguments also suggest that including anti-corruption reform as a condition attached to budget support, will probably not have much of an impact in highly corrupt countries.

Where budget support conditionality is ineffective due to corruption, donors should promote reform by other means. One way to make donor sanctions more credible, is to require pre-qualification for budget support, where some level of institutional development has to be attained before budget support is given. This would imply selectivity in the use of budget support.

Sequencing PFM reform and budget support to avoid increased corruption

Reform of the public financial management system is particularly important for the effectiveness of budget support. One argument used for budget support is that channelling funds through the PFM system of a country will serve to strengthen that system. It should be pointed out, however, that this is not an inevitable result of

budget support. In line with the general observations on conditionality, the prime determinant of PFM reform will be domestic political factors. Reform will thus only be implemented if it has domestic political backing.

To efficiently allocate funds, the PFM system as a whole must be well-functioning, from budget planning, through execution, to audits and control. Given the poor state of the system in many developing countries, ideally all parts of the PFM system should be improved. Given resource constraints, this is hard to do, and reform is therefore often done partially and sequentially. In sequencing PFM reform, one should be careful that the sequencing is not done in a way which creates greater incentives for corruption. The following example from Cambodia illustrates that agreements between donors and partner countries on the sequencing of PFM reform do run this risk in practice. To the extent that sequencing of this kind is necessary for other reasons, budget support should not be phased in until the necessary checks and balances are in place to prevent its misuse.

An example of sequencing problems: PFM reform in Cambodia

At present, Cambodia has a very weak PFM system, with significant weaknesses in budgeting, accounting, auditing, cash management, and a general lack of skilled staff and capacity. Cambodia is also a society characterized by extensive corruption. Though the country is not among the 146 countries ranked in the 2004 Transparency International Corruption Perceptions Index, Cambodia ranks on a par with Malawi and Uganda on the 2002 KKZ corruption index.

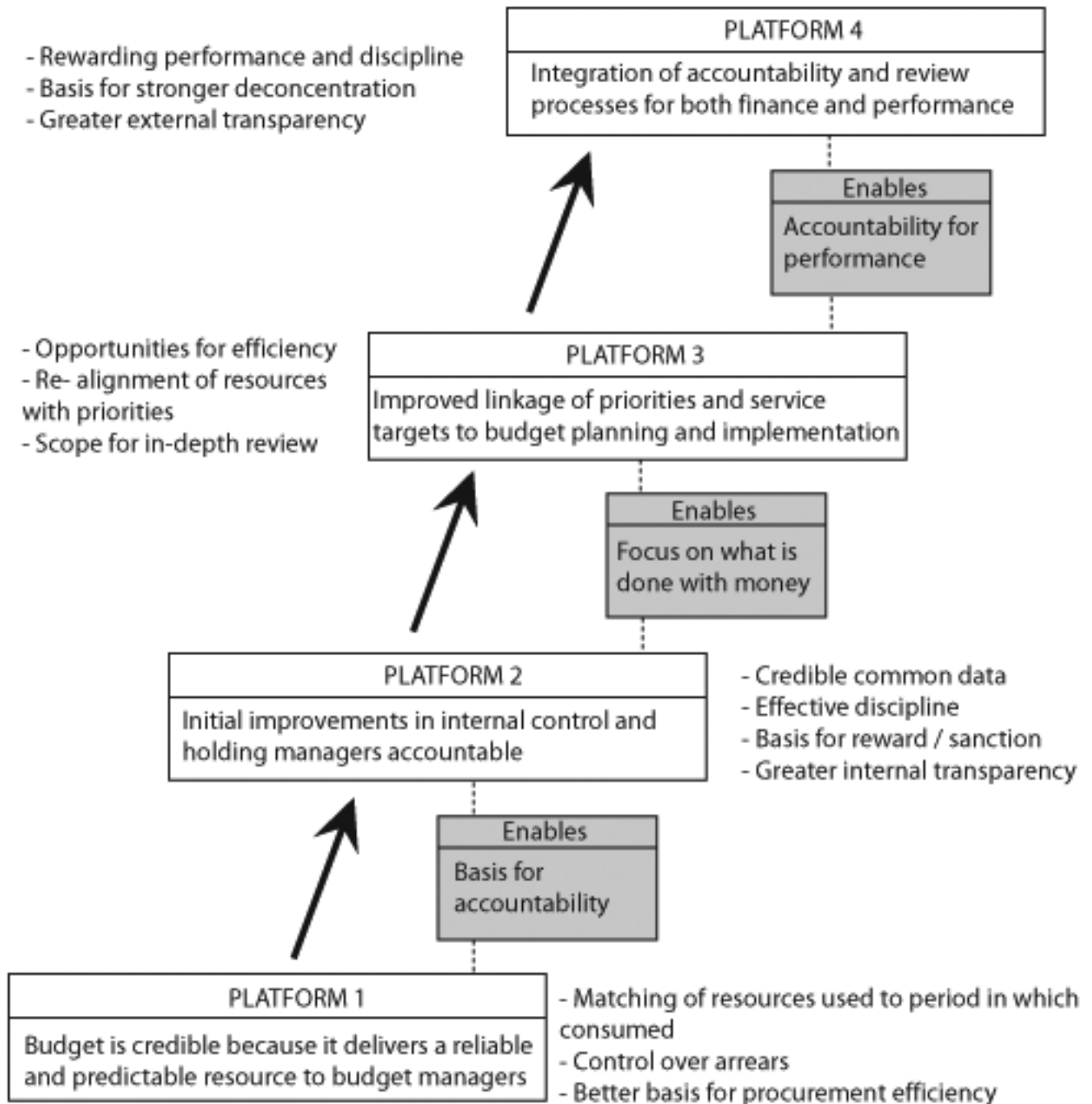
To improve the PFM system of Cambodia, a group of donors including the World Bank, has reached an agreement on a Public Financial Management Reform Programme with the Cambodian government. The programme was to commence in September 2004, and was divided into four stages or platforms. As the figure (below) shows, the first stage focuses on getting a credible and reliable budget in place. The second stage consists of steps to improve internal control and accountability, the third stage focuses on linking policy to budget planning and implementation, and the fourth on accountability, decentralization and integration of the PFM system through information technology.

The first two stages illustrate the disadvantage of having to pursue a stepwise approach to PFM reform in an environment characterized by corruption. In the first stage, resources will be channelled towards budget realism. This may divert resources and attention from other important functions of the PFM system, such as internal control. And relaxing whatever control mechanisms may be in place (though not intentionally), will make the risk of corrupt activities smaller, and therefore lead to an increase in corruption in the PFM system. One should thus not be too surprised if the incidence of corruption in fact increases during the first phase of the reform programme.

This has implications for the use of budget support. An increased flow of funds into a PFM system in which internal controls are being relaxed, increases the potential benefits while reducing the risk of corrupt activities. Providing budget support during the first stage of such a reform process, would thus add to the problem of relaxed controls, and lead to an even greater increase in corrupt activity. A prudent policy would therefore be to not give budget

support until the necessary control and accountability mechanisms are in place, that is after the completion of stage two, at the earliest.

Sequence of platforms - Public financial management



5. RENT-SEEKING IN FRACTIONALIZED SOCIETIES

Budget support increases corruption in fractionalized societies

Budget support can have direct consequences for corruption in a partner country. Several mechanisms through which budget support can affect corruption have been suggested. This section explores two mechanisms by which budget support can increase corruption, and one through which it can decrease corruption:

- Budget support increases rent-seeking in fractionalized societies
- Budget support shifts the political balance
- Increased public sector wages do not automatically reduce corruption

Budget support increases rent-seeking in fractionalized societies

In societies characterized by competing social groups, foreign aid increases the level of corruption. This is the conclusion of a cross-country study conducted by a World Bank economist, where ethnic fractionalization is used as a measure of social group competition. Though the result might apply to aid in general, the reasoning used to explain the result suggests that it is highly relevant for programme support in general, and budget support in particular.

The basic idea is that social groups compete for a common resource, and the larger the resource is, the greater is the incentive for each group to deviate from a collective agreement on its use. An increase in the resource will therefore lead to increased rent-seeking activity, as the groups all try to appropriate a share of the common resource. The public budget can be seen as one type of common resource to be fought over, and as budget support directly increases the size of the public budget, it can promote rent-seeking activity. If aid is less than perfectly fungible, a \$1 increase in project support will lead to less than a \$1 increase in public funds to be fought over, and project support will be less vulnerable to these types of mechanisms.

Countries characterized by ethnic (and possibly other) divisions, are therefore not good candidates for budget support. Accordingly, fiduciary risk assessments related to budget support, should include measures of fractionalization.

Budget support shifts the political balance

General budget support favours central government over other institutions. In societies where the central government is subject to the effective scrutiny of parliament, the media, and civil society, this might not pose too much of a problem. However, one risk in the current reallocation of aid towards budget support, is that institutions other than the central government are marginalized. For instance, if less aid is channelled through NGOs, these may

become less powerful in respect to the central government, and therefore be less able to hold the government accountable for its actions. And if the forces that hold the government accountable are weakened, a corrupt government can appropriate more of the public funds without facing serious consequences.

A reallocation of aid towards budget support, can thus shift the political balance in a way that facilitates political corruption. In assessing the appropriateness of budget support, donors should therefore look beyond the technical aspects of the PFM system, and also include analyses of the balance of power in partner countries, and how this is affected by different aid modalities.

Increased public sector wages do not automatically reduce corruption

It is sometimes argued that through increased public sector wages, budget support decreases corruption in the public bureaucracy. This requires two things. Firstly, that budget support is actually used to increase real wages in the public sector. Secondly, that the wage increases are effective in combating corruption. Domestic politics would determine whether the first condition is met. And if corruption is sufficiently widespread, general wage increases would be very costly, and partial wage increases politically problematic.

Even if wages were to increase as a result of budget support, this does not immediately entail that corruption is reduced. Studies show that the wage increases needed to change behaviour in developing countries' public bureaucracies are huge. In addition, wage increases would in many cases have to be supplemented by other changes, in organization, control mechanisms, and so on, to have an impact on corruption. In some cases, wage increases may actually spur corruption where the more attractive jobs are privately auctioned to the highest bidder. For more on wages and corruption, see *Autonomy, Incentives and Patronage - A Study of Corruption in the Tanzania and Uganda Revenue Authorities*.

One should therefore be careful in assuming that promises to use budget support on public sector remuneration are credible, and even if credible, that increased wages automatically reduce corruption.

6. IMPLICATIONS FOR FIDUCIARY RISK ASSESSMENTS

Implications of corruption for fiduciary risk assessments

Efficient use of budget support requires a good public financial management (PFM) system. Donors have used a diverse set of assessment tools to evaluate whether the PFM system of a partner country is of the necessary quality. Recently, a harmonized framework for assessing fiduciary risk has been developed by a Public Expenditure and Financial Accountability (PEFA) working group. Several donors have signalled that they will substitute the PEFA framework for older methods of assessment. This section therefore primarily looks at how the PEFA framework relates to corruption. Many of the arguments here, will nevertheless be valid for other PFM assessment frameworks, an overview of which can be found in the DFID How to note on "Managing Fiduciary Risk when providing

Poverty Reduction Budget Support” – see link in the reference list .

- PEFA framework does not incorporate corruption
- Some determinants of corruption captured by PEFA framework
- Corruption should be a part of fiduciary risk assessments: Here's how.
- PEFA framework does not incorporate corruption

The PEFA framework consists of 31 high level indicators that assess the PFM system of a partner country. These indicators seek to assess the operational performance of PFM systems, processes, and performance against six critical objectives of a PFM system:

- Credibility of the budget
- Comprehensiveness and transparency
- Policy-based budgeting
- Predictability and control in budget execution
- Accounting, recording and reporting
- External scrutiny and audit

The indicators are structured into four categories:

1. **PFM system outturns:** Aggregate expenditures and revenues, and composition of expenditures compared to original approved budget, plus stock and accumulation of arrears.
2. **Cross-cutting features:** Comprehensiveness of budget and the scope, content, and classification of fiscal information. Transparency of fiscal information.
3. **Budget cycle:** Performance of systems, processes, and institutions within the budget cycle, in terms of planning and budgeting, budget execution, accounting and reporting, and external accountability.
4. **Donor practices:** Practices which impact performance of country PFM system.

The PEFA framework contains no direct indicator of corruption.

Some determinants of corruption captured by PEFA framework

Though the PEFA framework does not explicitly address corruption, it does contain some indirect indicators of corruption. Some of the PFM characteristics captured by the framework, will in part determine whether corruption will flourish or not. Comprehensiveness and proper classification of the budget and fiscal information, implies that officials will find it harder to divert or misuse public

funds. Transparent and good fiscal information available to the public will make misuse easier to detect, and increase the accountability of public officials to the general public. The effectiveness of internal and external control clearly influences the possibility of detecting corruption.

Nevertheless, the PEFA framework is inadequate for capturing corruption. Important determinants of corruption are left out and the indicators are therefore insufficient to judge whether corruption is likely to be high or low in the country assessed. In particular, the indicators of central government accountability focus largely on the characteristics of control mechanisms rather than the ability of other agents to sanction government officials where misuse of funds occurs:

- Indicator 20 of the effectiveness of internal control assesses whether the control system is relevant, comprehensive, and cost efficient. It does not reflect whether cases of misuse detected by the system have any implications for corrupt officials.
- Indicator 27 of legislative scrutiny, reflects only whether the budget bill is rigorously debated, with sufficient scope, good procedures, and sufficient review time, it does not say whether the legislature has any power to amend the bill.
- Indicator 28 of legislative scrutiny of external audits and budget execution, asks only whether audits are reviewed by a legislative committee in a timely and thorough fashion, and looks at the actions recommended by the legislature. It does not capture whether adequate sanctions are in fact imposed, or whether the legislature has the power to enforce them.

The PEFA framework is by and large a technical summary of the PFM system of a country. It therefore also leaves out political and cultural characteristics that may influence corruption. For instance, we know from a study of Malawi that the budget process resembles a theatre play while the real allocation decisions are taken elsewhere. A framework that evaluates how well this *theatre* performs, is unlikely to inform us of the real quality of the PFM system of a country.

In relation to budget support, an important question is whether aid is likely to increase corruption in a given country. This is also a question that cannot be answered only by looking at the quality of the PFM system. Since budget support increases corruption in fractionalized societies, decisions of whether or not to give budget support should incorporate some indicator of the degree of fractionalization.

Corruption should be a part of fiduciary risk assessments. Here's how:

Corruption influences the degree to which budget support is effective in promoting development. There are also situations where budget support can increase corruption. Decisions of whether to give budget support should therefore include an assessment of corruption related risks. In this assessment, indicators of the following should be employed:

1. **Level of corruption:** Discretionary funds are allocated in a less productive and less pro-poor way in corrupt countries.

2. **Fractionalization:** Budget support increases corruption in fractionalized societies.
3. **Political corruption:** High level corruption may damage effect of budget support.
4. **Corruption according to sector:** If islands of integrity exist, sector budget support may be used.

The case for including indicators of the first two issues is very clear. At present, indicators of the level of corruption and fractionalization do exist (see Transparency International's Corruption Perceptions Index and the PRS Group's International Country Risk Guide). The need for indicators of political corruption and a breakdown according to sectors is based on less evidence, but should be included to err on the side of caution until further analyses are performed.

Indicators of these two issues are to our knowledge, not readily available and will have to be developed.

In addition to the four indicators specified above, a more thorough analysis may be needed of how budget support would affect the underlying causes of corruption in a particular partner country. One important aspect of this is how budget support to the central government may change the political balance in a country.

A question which must be settled in adding indicators of corruption, is their status in relation to other fiduciary risk indicators, for instance as defined by the PEFA framework. A disadvantage of the PEFA framework, is that it does not explicitly address how bad the score can be before budget support becomes inappropriate, nor is it obvious how much weight each of the 31 indicators should have when deriving an aggregate assessment.

Adding corruption indicators could thus mean that corruption could be given no weight in practical allocation decisions.

This is an argument for doing a separate analysis of corruption. Though a more thorough analysis is needed to conclude on this point, the general conclusion that corruption related issues should influence the decision of whether or not to give budget support, stands.

7. RELEVANT LINKS AND RESOURCES

U4 agencies' policy documents and resources

DFID:

Managing fiduciary risk when providing poverty reduction budget support - DFID Briefing note - pdf:
<http://www.dfid.gov.uk/aboutdfid/organisation/pfma/pfma-fiduciary-briefing.pdf>

Managing fiduciary risk when providing poverty reduction budget support - DFID How to note - pdf:
<http://www.dfid.gov.uk/aboutdfid/organisation/pfma/pfma-fiduciary-howtonote.pdf>

Managing Fiduciary Risk When Providing Direct Budget Support - DFID issue note - pdf:
<http://www.dfid.gov.uk/pubs/files/pfma-fiduciaryrisk.pdf>

SIDA:

Public financial management - pdf:
http://www.sida.se/content/1/c6/03/38/08/SIDA4531en_PFM%20web.pdf

Programme Support and Public Financial Management - pdf:
http://www.sida.se/content/1/c6/03/38/13/SIDA4532en_WP%202005-2%20web.pdf

Programme Support and Public Finance Management - A New Role for Bilateral Donors in Poverty Strategy Work - pdf:
<http://www.sida.se/Sida/articles/10200-10299/10280/Sida%20Studies%20no%206.pdf>

Sida's Policy for Sector Programme Support - pdf:
<http://www.sida.se/content/1/c6/02/11/17/Sida%20Policy%20SPS.pdf>

PEFA Public Financial Management Performance Measurement Framework - pdf:
http://www.sida.se/content/1/c6/03/38/14/SIDA4533en_WP%202005-3%20web.pdf Best Practice in Building African Capacity for Public Financial Management - pdf

Best Practice in Building African Capacity for Public Financial Management - pdf:
http://www.sida.se/content/1/c6/02/28/86/SIDA3149en_BestPractice.pdf

NORAD:

Norad's position on direct budget support - downloadable pdf:
http://www.norad.no/default.asp?V_ITEM_ID=2399

Direct budget support, disbursement mechanisms and predictability - downloadable pdf:

http://www.norad.no/default.asp?V_ITEM_ID=3154

Other agencies/organizations' policy documents and resources

DEVELOPMENT EXPERIENCE CLEARING HOUSE

General budget support and sector program assistance - Malawi country case study - downloadable pdf:

http://www.dec.org/search/dexs/index.cfm?fuseaction=Dexs.citation&rec_no=133048

What conditions favor the success of general budget support and sector program assistance? - Malawi country case study - downloadable pdf:

http://www.dec.org/search/dexs/index.cfm?fuseaction=Dexs.citation&rec_no=130183

General budget support in Tanzania - a snapshot of its effectiveness - downloadable pdf:

http://www.dec.org/search/dexs/index.cfm?fuseaction=Dexs.citation&rec_no=128683

General budget support - an alternative assistance approach - Mozambique country case study - downloadable pdf:

http://www.dec.org/search/dexs/index.cfm?fuseaction=Dexs.citation&rec_no=128501

What conditions favor the success of general budget support? - Mozambique country case study - downloadable pdf:

http://www.dec.org/search/dexs/index.cfm?fuseaction=Dexs.citation&rec_no=125773

WORLD BANK

Assessing and reforming public financial management - A new approach - pdf:

http://www-wds.worldbank.org/servlet/WDSContentServer?WDSPath=/IB/2004/01/15/000090341_20040115131609/Rendered/PDF/275840PAPER0Assessing0and0reforming.pdf

IMF

Corruption, Growth, and Public Finances - downloadable pdf:

<http://www.imf.org/external/pubs/cat/longres.cfm?sk=3854.0>

Budget Support versus Project Aid - downloadable pdf:

<http://www.imf.org/external/pubs/cat/longres.cfm?sk=16445.0>

INTERNATIONAL DEVELOPMENT DEPARTMENT

Joint Evaluation for General Budget Support - web page:

<http://www.idd.bham.ac.uk/general-budget-support/>

PEFA - PUBLIC EXPENDITURE & FINANCIAL ACCOUNTABILITY

PEFA home page:

<http://www.pefa.org/index2.htm>

OECD

Working Party on Aid Effectiveness and Donor Practices - Draft Good Practice Note on the Provision of Budgetary Support - A Public Financial Management Prospective - pdf:

<http://www.oecd.org/dataoecd/55/0/34065366.pdf>

Harmonising Donor Practices for Effective Aid Delivery - Volume 2: Budget Support, Sector And Capacity Development Financial Management - pdf:

<http://www.oecd.org/dataoecd/53/7/34583142.pdf>

Meeting of the Joint Venture on Public Financial Management - web page:

http://www.oecd.org/document/46/0,2340,en_2649_15587066_33868014_1_1_1_1,00.html

ODI OVERSEAS DEVELOPMENT INSTITUTE

The Choice of Financial Aid Instruments - pdf:

http://www.oecd.org/document/46/0,2340,en_2649_15587066_33868014_1_1_1_1,00.html

Academic papers and books

Foreign aid and rent-seeking (Jakob Svensson) - pdf:

<http://www.iies.su.se/~svensoj/1632.pdf>

Why conditional aid does not work and what can be done about it? (Jakob Svensson) - pdf:

[http://www.iies.su.se/~svensoj/JDE2003\(70\).pdf](http://www.iies.su.se/~svensoj/JDE2003(70).pdf)

When is foreign aid policy credible? Aid dependence and conditionality (Jakob Svensson) - pdf:

[http://www.iies.su.se/~svensoj/JDE2003\(70\).pdf](http://www.iies.su.se/~svensoj/JDE2003(70).pdf)

Other references (not on web)

White, H. N. and Dijkstra, A. G. (2003), Programme aid and development - Beyond conditionality, London: Routledge

U4 is a web-based resource centre for donor practitioners who wish to effectively address corruption challenges in their work. We offer focused research products, online and in-country training, a helpdesk service and a rich array of online resources. Our aim is to facilitate coordination among donor agencies and promote context-appropriate programming choices.

The centre is operated by the Chr. Michelsen Institute (CMI – www.cmi.no), in association with Transparency International. CMI is a private social science research foundation working on issues of development and human rights, located in Bergen, Norway.

U4 Partner Agencies: DFID (UK), Norad (Norway), Sida (Sweden), Gtz (Germany), Cida (Canada), and the Netherlands Ministry of Foreign Affairs.

www.U4.no

U4 - CMI
PO Box 6033
5892 Bergen, Norway
Tel: +47 55 57 40 00
U4@U4.no