

SHOULD CORRUPT COUNTRIES RECEIVE BUDGET SUPPORT?

Corruption makes budget support ineffective, and sometimes counter-productive. Budget support is particularly unsuitable in partner countries where political corruption is rampant. As donors increase budget support, it is a paradox that corruption is not more of an issue in evaluations and public financial management assessment methods.

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

By leaving aid allocation decisions to partner country governments, budget support is intended to promote aid efficiency, and improve the public financial management (PFM) system of partner countries. Whether budget support delivers on these promises, is the topic of a multi-donor evaluation currently underway.

It is widely recognized that budget support requires a well-functioning PFM system to be effective. To determine which countries are eligible for budget support, donors therefore employ various PFM assessment tools.

The issue of corruption is not explicitly covered by the commonly employed assessment tools. Nor is corruption likely to be a major theme of the multi-donor evaluation, according to informed sources.

This brief reviews the available evidence on corruption and budget support, which suggests that corruption deserves more attention in analyses of budget support effectiveness.

WHAT IS BUDGET SUPPORT?

Budget support is aid transferred to the partner government's National Treasury, to be managed by means of the beneficiary's budgetary procedures. By contrast, project support is aid transferred to fund predetermined projects. Budget support is usually policy-based aid (with conditions attached), and coordinated among several donors (basket funding).

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. Budget support is also sometimes characterized according to the conditions attached. Poverty reduction budget support hence denotes budget support whose conditions and dialogue focus on poverty reduction strategies.

CORRUPTION CHANGES BALANCE OF ARGUMENTS

The following is a list of standard arguments for providing budget support:

- Increased ownership
- Increased accountability
- Facilitation of dialogue
- Aid is fungible, and project support costly
- Facilitation of donor coordination and harmonization
- Improved institutional capacity and allocative efficiency in partner countries
- Predictable development funding
- Flexible and quickly disbursable

Corruption significantly affects the former four arguments, thus weakening the case for budget support.

Increased ownership - and discretion

Budget support increases ownership of the development process by the partner country, almost by definition. Provided, of course, that conditionalities are not too intrusive.



Discretion is, however, the other side of the ownership coin. From the corruption literature, we know that granting public officials greater discretion, can lead to an increase in corruption. 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.

We also need to consider 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.

Case for increased accountability unclear

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. The case for this is far from clear, however. A recent evaluation of budget support to Tanzania, concludes that improved democratic accountability is not automatic. An evaluation of budget support to Mozambique, similarly argues that "the press, parliament, and civil society are no match for the government – they have a difficult time improving accountability or reducing corruption".

Facilitation of dialogue – or cheap talk

Budget support involves a process of dialogue between donor and partner countries. Dialogue is useful to clarify ends and expectation and to coordinate efforts. Talk is cheap, however, and unlikely to produce actions that are not in the interest of partner country governments.

In countries with corrupt governments, dialogue is unlikely to result in concrete action, if the rents available to government officials are thereby reduced. Recent experience from Uganda suggests that corrupt high level officials will attempt to undermine effective anti-corruption reform, for instance by cutting funding of anti-corruption agencies.



Project support sometimes worth the extra cost

The transaction costs of project support are likely to be higher than for budget support. At the same time, funds are fungible: A partner country government can reallocate aid given to a specific project or sector, by simply reducing its own funding of that project or sector. Incurring the extra cost of project support, when funds are reallocated anyway, does not make too much sense.

For heavily aid dependent economies, however, aid need not be perfectly fungible. The greater control over the use of funds must then be weighed against the added cost of project support. If budget support entails greater spending on activities donors disapprove of (such as the military, or corrupt activities), project aid may be worth the extra cost.

CORRUPTION REDUCES IMPACT OF BUDGET SUPPORT

At the end of the day, budget support should be judged by its effect on growth and poverty. Corruption affects which type of aid is more effective in promoting growth and alleviating poverty.

Budget support not advisable in highly corrupt countries

Budget support works better where institutions are good, project support where institutions are bad. This is the conclusion of an IMF study using an aggregate index of institutions. There is as yet no empirical study of the specific impact of corruption on the effect of budget support versus project support.

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.

Political corruption makes budget support particularly unsuitable

While petty corruption decreases the effectiveness of any type of aid, political corruption is relatively more detrimental

to budget support. The bad performance of budget support in Malawi can in part be attributed to a high degree of political corruption, according to a USAID evaluation.

The reason political corruption is particularly bad for budget support, can be explained by means of the below figure. The figure very roughly sketches the relevant differences between budget and project support. Via project support donors have some influence on the allocation of funds to different activities such as building schools, roads, hospitals etc. With budget support, the allocation decision is left to the partner government. If funds are not fully fungible, and donor and partner country preferences different, the activities funded under project support (A and B), will be somewhat different from those funded by budget support (B and C).

Without additional information, it is difficult to know whether the activities resulting from one type of aid are systematically more vulnerable to corruption than those resulting from the other. The difference in the impact of corruption on the two aid modalities, is rather due to differences at the allocation level. If there is substantial political corruption in the partner country, and donors are relatively clean, allocations will be skewed in a way that benefits the political elite under budget support, relative to project support.

Budget support counter-productive in fractionalized societies

In societies characterized by competing social groups, foreign aid increases the level of corruption. An empirical study by a World Bank economist documents that this insight applies specifically to ethnically

divided countries.

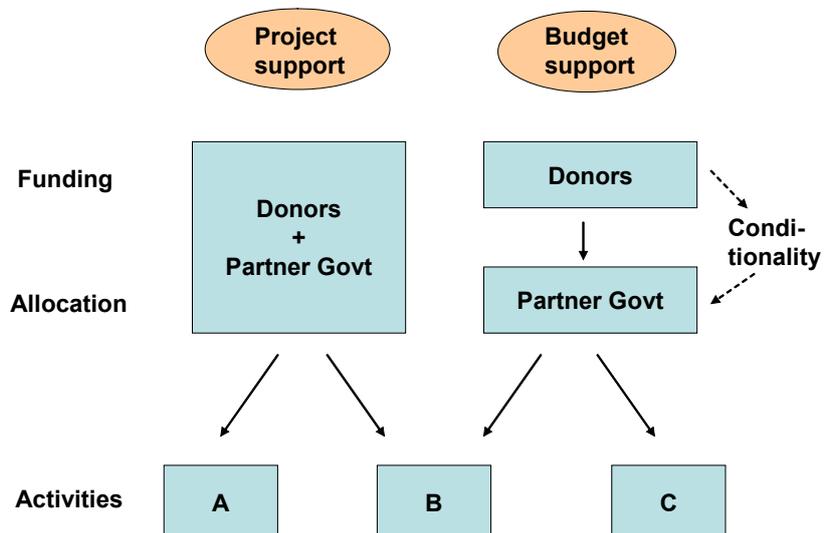
The basic mechanism here is that the social groups compete for a common resource, and the larger the resource is, the greater is the incentive for each group to deviate from a collective agreement on its use. An increase in the resource will therefore lead to increased rent-seeking activity, as the groups all try to appropriate a share of the common resource.

The public budget is one type of common resource to be fought over. As budget support directly increases the size of the public budget, it can promote competition between social groups, resulting in greater 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, as there is a risk that corruption will increase.

CORRUPTION NOT COVERED BY FIDUCIARY RISK ASSESSMENT TOOLS

To assess the quality and characteristics of the public financial management (PFM) systems of partner countries, donors employ various types of fiduciary risk assessment tools. 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.



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PEFA framework does not incorporate corruption

The PEFA framework consists of 31 high level indicators that assess the PFM system of a partner country. It contains no direct indicator of corruption, however.

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, makes misuse easier to detect, as does effective internal and external control.

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.

In sum, the PEFA framework provides more of a technical summary of a PFM system, omitting important political and cultural aspects relevant for corruption.

CONCLUSIONS

In scaling up aid, it is tempting to resort to aid modalities that facilitate easy disbursement. Though budget support is suitable for partner countries with good institutions, it is a poor choice where institutions are weak.

Corruption makes budget support ineffective, and in some countries even counter-productive. Giving budget support to highly corrupt countries, such as Bangladesh, or countries with a high degree of political corruption, such as Malawi, is therefore unlikely to spur development.

If budget support evaluations and fiduciary risk assessments do not pay sufficiently attention to the issue of corruption, allocations of budget support are bound to be flawed.