

U4 Expert Answer



Literature review: Corruption risks in development aid

Query

Which corruption risks are associated to the carry-over development aid funds?

Content

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Caveat

Despite extensive research, the Helpdesk team could not find evidence linking the carry-over of unspent development aid flows to the increase of corruption risks in a country. The literature suggests, however, that underspending is more an indication of donor interventions that fail to consider contextual variables such as the institutional setting of recipient countries and their resulting absorption capacity. Due to the urgency of this query, the content is only meant to provide a very broad overview of the main discussions regarding aid effectiveness and corruption risks in development aid rather than a thorough review of the literature on the topic.

Summary

This Expert Answer provides some background on the debate around aid effectiveness, which is often measured as the impact of aid on poverty or economic growth in recipient countries. The highlights the importance of taking into account contextual variables, such as a countries institutional framework and its “absorption capacity” when designing aid programmes to avoid harming the recipient countries’ economy. In the final section, the answer explores some of the recommendations found in the literature to design successful aid programmes and provides a list of relevant resources for this discussion.

Author(s): Roberto Martinez B. Kukutschka, tihelpdesk@transparency.org

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1. The aid effectiveness debate

According to [OECD statistics](#), official development aid (ODA) has been on the rise for the past two decades. In 2016, ODA from OECD countries reached a record high of 143.3 billion dollars, which represents an increase of almost 9% from the previous year and more than double of total disbursed in 1996. Foreign aid is often designed to meet one or more of the following objectives:

- stimulate economic growth by building infrastructure, supporting productive sectors such as agriculture, or bringing new ideas and technologies,
- strengthen education, health, environmental, or political systems,
- support subsistence consumption of food and other commodities, especially during relief operations or humanitarian crises, or
- stabilize an economy following economic shocks.

Despite these broader objectives for aid, economic growth has always been the main yardstick used to judge its effectiveness, with more aid expected to lead to faster growth. The literature on the topic has struggled to find a simple relationship between the levels of aid received by a country and its levels of economic growth. Empirical evidence has been provided in favour of the following lines of thought:

- aid fuels economic growth (Burnside and Dollar 2000; Guillaumont and Chauvet, 2001; Hansen and Tarp, 2001; Collier and Dollar 2002; Gomanee, Girma, and Morrissey, 2002; Dalgaard, Hansen and Tarp, 2004; Clemens, Radelet and Bhavnani, 2004),
- aid is growth-neutral (Boone 1994, 1996; Easterly, Levine and Roodman 2004; Easterly 2005), and
- aid negatively impacts economic growth (Bobba and Powell 2007).

On one hand, authors who argue for the positive effect of aid on growth usually claim that these flows help finance investment and add to the capital stock. Under this view, aid is also seen as a channel for the transfer of technology or knowledge from donor to recipient countries by paying for capital goods imports, through technical assistance, or through direct transfer of technologies.

On the other hand, studies that find a neutral or negative effect of aid on economic growth, usually

highlight that aid can be wasted and that it can encourage corruption by providing incentives for rent-seeking and helping governments stay in power despite poor economic policies and lack of reform. It has also been argued that aid may inhibit development by creating a dependency mentality and overwhelming the management capacity of governments, crowding out private sector development (Bauer 1976; Krauss 1983), worsening bureaucratic quality (Knack and Rahman, 2007), weakening governance (Knack 2000; Rajan and Subramanian 2007), and lowering competitiveness (Rajan and Subramanian 2005).

Other authors have argued, however, that the effectiveness of aid depends on the characteristics of the recipient countries. In one of the most influential papers in the field, Craig Burnside and David Dollar (2000), conclude that aid stimulated growth in countries with good policies, but not otherwise. The appeal of this approach is that it **helps** explain why aid seems to have supported growth in some “well-behaving” countries but not in others. These findings have had an enormous impact on donors. The concept feeds directly into the World Bank’s Performance Based Allocation (PBA) system for distributing concessional International Development Association (IDA) funds, and was the foundation for the United States’ new Millennium Challenge Account (MCA) (Radelet, 2003).

A few recommendations for donors regarding the type of aid that they offer and the countries where these flows are directed have emerged from the debate on aid effectiveness briefly summarized above:

First, regarding the type of aid, Clemens, Radelet, and Bhavnani (2004), for example, show that emergency and humanitarian aid is likely to be negatively associated with growth, aid directed to the improvement of public service delivery or the quality of government might only affect growth after a long period of time, and aid that is directly aimed at developing infrastructure or supporting economic activity is often found to have a positive relationship to economic growth.

A second influential idea is that donors need to be more selective regarding the countries to which they provide aid, based on the view that aid works best in countries with good policies and institutions. In the strongest version, aid should be provided only to countries that meet these criteria. A more moderate view is that more aid should be allocated to countries with stronger policies and institutions.

2. The principle of absorption capacity

Over the past decade, a number of aid allocation models have been proposed by the academic literature (Cogneau and Naudet 2007; Collier and Dollar 2002; Llavador and Roemer 2001). Some of these models have been adopted by some multilateral and bilateral aid donors and many consider variables such as the size of a country's economy, the level of need and the potential to use aid effectively, i.e. a country's capacity to absorb development funds.

There are a number of issues that might limit a country's ability of recipient countries to put aid flows to good use. These include, for example:

- human and physical capital constraints;
- policy and institutional constraints;
- macroeconomic constraints;
- deficiencies in the manner in which the international donor community delivers its foreign assistance; and
- social and cultural constraints.

Several studies point at the notion that there are diminishing returns to aid (Bourguignon and Sundberg 2006; Clemens et al. 2012, Presbitero 2015). This means that development aid is found to be positively related to growth up to a certain level of aid relative to a recipient's GDP and negatively related thereafter. Some of the studies reporting diminishing returns to aid include Durberry et al. (1998), Collier and Dollar (2002), Collier and Hoeffler (2002), Hansen and Tarp (2000, 2001), Dalgaard and Hansen (2001), Hudson and Mosley (2001), Lensink and White (2001) and Dalgaard et al. (2004). These studies find that negative returns set-in when the aid inflow reaches anywhere between 15 and 45 percent of GDP (McGillivray 2004).

These findings have important implications for the inter-country allocation of aid. As donors continue to scale-up their assistance, it is important that the effectiveness of aid at promoting growth and reducing poverty is not compromised by over-aiding recipients relative to their levels of absorptive capacity (Feeny and McGillivray, 2011). In order to maximize the impact of aid, therefore, absorptive capacity should be included in models and formulae which guide the allocation of aid across countries.

Taking a country's absorption capacity into account when allocating aid is particularly important to help prevent corruption. According to some scholars, levels of aid that exceed a country's absorption capacity could exacerbate corruption and harm recipient governance. This could especially when aid flows are not aligned to the needs and capacities of the recipient countries (Galtung and Tisné 2009). As a result, many of the funds directed to the country may remain unspent.

In short, aid providers need to improve own systems for corruption control, but also work better with developing country governments to align assistance and help build up national capacity to prevent corruption. The concept of 'do no harm' is therefore central. Development should not work as a driver of conflict, and corruption is an important intermediary force. 'Do no harm' in relation to anti-corruption programming means.

Avoiding premature or poorly-thought-out reforms that can do more harm than good—notably, steps that overwhelm a society's capacity to absorb aid and put it to effective use, and that risk pushing fragile situations and societies into particular kinds of corruption that are severely disruptive.' (Johnston 2010)

3. Best practices in aid design

While there is no one-size fits all model to guarantee the success and effectiveness of aid, the development community has undertaken several efforts to increase impact. [The Paris Declaration](#) (2005), for example, is a practical, action-oriented roadmap to improve the quality of aid and its impact on development. It gives a series of specific implementation measures and establishes a monitoring system to assess progress and ensure that donors and recipients hold each other accountable for their commitments. The Paris Declaration outlines the following five fundamental principles for making aid more effective:

- **Ownership:** Developing countries set their own strategies for poverty reduction, improve their institutions and tackle corruption.
- **Alignment:** Donor countries align behind these objectives and use local systems.
- **Harmonisation:** Donor countries coordinate, simplify procedures and share information to avoid duplication.

- Results: Developing countries and donors shift focus to development results and results get measured.
- Mutual accountability: Donors and partners are accountable for development results.

Designed to strengthen and deepen implementation of the Paris Declaration, the Accra Agenda for Action takes stock of progress and sets the agenda for accelerated advancement towards the Paris targets. It proposes the following four main areas for improvement:

- Ownership: grant recipient countries more say the aid flows they receive through wider participation in development policy formulation, stronger leadership on aid co-ordination and by using existing country systems for aid delivery.
- Inclusive partnerships: All partners - including donors in the OECD Development Assistance Committee and developing countries, as well as other donors, foundations and civil society - participate fully.
- Delivering results: focused aid on real and measurable impact on development.
- Capacity building: focus on building the ability of countries to manage their own future

In their paper, [Rhetoric versus Reality: The Best and Worst of Aid Agency Practices](#), Easterly and Williamson (2010) identify five “best practices” that have been prominently featured in the Paris Declaration, aid agency documents and academic literature alike. These include:

- maximum transparency;
- minimal overhead expenses;
- specialization of programs by sector or country;
- delivery through more effective channels; and
- selective disbursement of aid based on poverty and good government.

The authors point out that certain types of aid delivery tend to be more effective than others and highlight that tied aid and technical assistance, for example, are widely seen as a way for donor countries to promote their own commercial interests above the development needs of recipient countries. Food aid is also recognized as an inefficient way to provide assistance, as it frequently undermines local and regional agricultural markets (Easterly and Williamson 2010).

4. Recommended resources

The debate around aid effectiveness

[Aid, policies and growth](#)

Craig Burnside and David Dollar (2000)

The authors of this paper use a new database on foreign aid to examine the relationships among foreign aid, economic policies, and growth of per capita GDP. In panel growth regressions for 56 developing countries and 6 four-year periods (1970-93), they find that the policies that have a great effect on growth are those related to fiscal surplus, inflation, and trade openness. They construct an index for those three policies and have that index interact with foreign aid. They have instruments for both aid and aid interacting with policies. They find that aid has a positive impact on growth in developing countries with good fiscal, monetary and trade policies. In the presence of poor policies, aid has no positive effect on growth. This result is robust in a variety of specifications, which include or exclude middle-income countries, include or exclude outliers, and treat policies as exogenous or endogenous. They examine the determinants of policy and find no evidence that aid has systematically affected policies, either for good or for ill. They estimate an aid allocation equation and show that any tendency for aid to reward good policies has been overwhelmed by donors' pursuit of their own strategic interests. In a counterfactual, they reallocate aid, reduce the role of donor interests and increasing the importance of policy. Such a reallocation would have a large positive effect on developing countries' growth rates.

[Aid, policies and growth: Revisiting the evidence](#)

Craig Burnside and David Dollar (2004)

This paper revisits the relationship between aid and growth using more data focusing on the 1990s. The evidence supports the view that the impact of aid depends on the quality of state institutions and policies. The authors find that the interaction of aid and institutional quality has a robust positive relationship with growth and that there is no support for the competing hypothesis that aid has the same positive effect everywhere. The paper also reveals that the aid allocated in the 1990s to low-income countries favored ones with better institutional quality. This “selectivity” is

sensible if aid in fact is more productive in sound institutional and policy environments.

Macro Aid Effectiveness Research: A guide for the Perplexed

David Roodman (2007)

This paper reviews recent, contending studies of how much foreign aid affects country-level outcomes. The study focuses on the effects of aid on economic growth and school attendance rates. The author provides a comprehensive review of the literature around aid effectiveness and the debate around it and show how quantitative studies have often failed to capture the impact of aid flows. More importantly, the paper analyses the literature to identify areas of consensus among authors in terms of what works to make aid more effective.

Absorption capacity

Absorptive Capacity: How much is too much?

Michael Clemens & Steven Radelet (2003)

This chapter clearly frames the issue of absorptive capacity. It explains how countries might struggle to put aid flows to good use when these exceed a country's absorption capacity and how too much aid can also threaten a country's macroeconomic stability by, for example, appreciate exchange rates. The authors also conduct an exercise of calculating saturation points for a set of countries and recommend monitoring the rates of return on aid to avoid causing harm to recipient countries.

The Absorptive Capacity Limit: The point where too much aid becomes bad aid

Institute for State Effectiveness (2017)

This policy note offers a comprehensible overview of the challenges associated to low levels of absorptive capacity. It explains, for example, how too much aid impacts the effectiveness of all existing aid in a country thus threatening development. The authors highlight that one of the main responsibilities for donors is to allocate aid in a way that does not threaten the performance of a recipient government by providing either too much or too little financial assistance, or too much of the wrong type assistance.

An Analytical Overview of Aid Absorption: Recognizing and Avoiding Macroeconomic Hazards

David L. Bevan (2005)

This paper summarizes the main issues associated to aid inflows that become too large relative to the recipient economy. The author offers a review of the main concerns about the danger of institutional damage, and what may be done to reduce this. The paper also considers a narrower set of questions, including: absorptive capacity constraints, and how to reduce the costs of recognizing them and of responding to them.

The (low) absorption of EU Structural Funds

Ivana Katsarova (2013)

This policy brief provides an overview of absorption capacity issues faced by the European Union in the allocation of Structural Funds ment to help reduce disparities between regions. These funds are allocated to Member States under a complex legal framework, according to the level of development of their regions. The EU has, however, faced challenges as the most economically disadvantaged regions are also experiencing the greatest difficulties in spending (absorbing) these funds. The brief identifies some of the reasons behind this, which include issues related to insufficient administrative capacity, changes in national/regional governments, and the effects of national sectoral reforms. The brief also a brief overview of the solutions implemented by the EU to tackle the issue, such as allowing a temporary increase of EU co-financing rates by 10% for those member states experiencing financial difficulties. Other measures included allowing for the carry-over of unspent funds, as well as the simplification of the rules and procedures to allocate funds in order to make funds more flexible and improve absorption.

Best practices in development aid design and implementation

Rhetoric versus Reality: The Best and Worst of Aid Agency Practices

William Easterly & Claudia R. Williamson (2011)

This paper monitors the best and worst of aid practices among donors and UN agencies. The authors create aid practice measures based on aid transparency, specialization, selectivity, ineffective aid channels and overhead costs and rate donor agencies from best to worst on aid practices. The paper also assesses trends in best practices over time and finds modest improvements in transparency and in moving away from ineffective channels to deliver aid.

Managing Aid: Practices of DAC Member Countries

OECD (2009)

This report analyses the practices which donors use to manage their foreign assistance to developing countries. The report shows that each DAC member country is unique in the way it manages and implements development co-operation and in the way they tackle challenges in the field. There are, however, lessons to be learned from the different experiences. This publication covers issues such as the legal frameworks for development co-operation; how DAC members promote coherent development policies; how they organise their operations at headquarters and in partner developing countries and manage their human resources; how they allocate aid between channels, countries, sectors and cross-cutting themes; what steps they have taken to make their aid more effective; how they gather evidence through monitoring and evaluation; and finally, how they manage humanitarian action. Annex A also provides a detailed description of how financial programming systems work in each DAC member country.

Corruption risks in development aid

Risks for development cooperation in fragile and transitional states

Maira Martini (2013)

This U4 Helpdesk answer looks provides an overview of the main areas of risk for development projects in fragile and transitional states. It identifies three main areas of concern, i.e. contextual (e.g. analysis of external facts which have an impact on developing programming such as security, economic and political environment), programmatic (e.g. risks of programme failure due to unrealistic approaches or unintended consequences), and institutional (e.g. fiduciary and reputational risks due to corruption).

Recommendation of the Council for Development Co-operation Actors on Managing the Risk of Corruption

OECD (2016)

The OECD Recommendation of the Council for Development Co-operation Actors on Managing Risks of Corruption promotes a broad vision of how international development agencies can work to address corruption, including the bribery of foreign public officials. It calls on countries to

encourage their international development agencies to ensure effective measures are in place to manage risks of, and respond to, actual instances of corruption in development co-operation. The Recommendation replaces the 1996 DAC Recommendation on Anti-Corruption Proposals for Bilateral Aid Procurement, extending its scope beyond procurement to take into account changes in the development environment and the involvement of new partners and channels for aid disbursement. The new Recommendation:

- Suggests measures to prevent and detect corruption in projects financed by official development assistance (ODA).
- Details sanctions to be provided in ODA contracts to enable agencies to respond adequately to all cases of corruption.
- Advises countries' international development agencies to work towards a comprehensive system for corruption risk management, including: codes of ethics; whistleblowing mechanisms; financial control and monitoring tools; sanctions; co-ordination to respond to corruption cases; and communication with domestic constituencies (tax payers and parliaments) on the management of corruption risks.

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