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Fiduciary safeguards for minimising corruption risks when using budget support

Query

What are the lessons on use of fiduciary safeguards for minimising risk in budget support and, in this context, how do bilateral and multilateral donors assess corruption? Which are the most common safeguards used to mitigate fiduciary risks and what are the strengths and weaknesses related to the use of these for partner governments as well as donors?

Content

Summary

It is usually assumed that budget support is more vulnerable to corruption than other forms of aid, as it can be directly affected by existing weaknesses in the recipient countries' public finance management (PFM) systems.

While donors usually do not consider corruption as a prohibitive factor to the provision of budget support, there is a broad consensus that diagnostic corruption information needs to be integrated into decisions on budget support operations. This is usually done in the form of ex-ante fiduciary risks assessments using tools such as the DFID's fiduciary risk assessment framework, the World Bank's analytical tools to assess procurement and PFM systems or the joint assessment framework known as the Public Expenditure and Financial Accountability (PEFA) performance framework. Although most of these fiduciary risk assessment tools do not comprehensively capture corruption risks, it is usually considered that conducting such assessments has a positive impact on the recipient countries' PFM systems and reform programs.

There are different types of risk mitigation strategies that can be used to address fiduciary risks over different timescales, including: 1) short term safeguards and arrangements facilitating the tracking and accounting of expenditures; 2) mechanisms for monitoring key corruption risks and related reforms in the medium term; and 3) a comprehensive programme of reforms to address corruption risks in PFM systems in the long run. Experience shows that while short and medium term arrangements are likely to reduce the reputational risks of donors, they do not substitute for more credible, coherent and sustainable reform approaches that address the underlying causes of corruption risks to PFM systems in a sustainable manner.

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Date: 6 April 2010 **Number:** 240

1 Corruption risks and the provision of budget support

Intended benefits of budget support

Budget support is meant to support a recipient government's programme of policies and institutional reforms intended to promote growth and reduce poverty. With budget support, aid is given directly to the recipient country's government in support of its national or sectoral budgets. In practical terms, this means that rather than being linked to specific project activities, the funds are transferred to the partner government's national treasury, and are managed through the government's own budgetary procedures and accounting systems.

Rationale behind using budget support

There is an abundant literature on the intended benefits of providing budget support within the aid effectiveness agenda and the theoretical arguments in favour of this "new" aid modality are relatively well known (Fritz, V., Kolstad, I., 2008). In addition to greater predictability of aid, budget support is expected to reduce high transaction costs that result from the multiplicity of donors' reporting and accounting requirements. Budget support is envisioned to promote the recipient country's ownership of development policies and increase both the institutional capacity and allocative efficiency of partner countries. Using country systems is also assumed to increase the effectiveness of the state and public administration by avoiding the establishment of special staffing arrangements and parallel structures. But the most compelling argument for using budget support is the intention to strengthen partner countries' domestic accountability to their own constituencies (rather than to the donor community) in the management of public resources through greater use of the government own accountability and review mechanisms (public account committees, external audit offices, etc).

Overall assessment of budget support

Findings of a joint evaluation of budget support commissioned by 24 aid agencies in 7 countries indicates that the overall assessment of budget support is mostly positive with regard to allocative and operational efficiency. It is also found to provide a stronger focus on poverty reduction, improved planning and budgeting processes (except for two countries), as well as better harmonisation and alignment of aid. However, the study could not track identifiable effects of using budget support on poverty reduction in most countries (IDD and associates, 2006).

A 2008 DFID evaluation of budget support corroborates these findings by concluding that budget support often enabled governments to increase expenditures on priority areas, help them expand their capacity and strengthen their financial management systems, even if at a slower pace of progress than expected (Comptroller and Auditor General, 2008).

Corruption risks when providing budget support

In spite of these positive outcomes, one of the main concerns associated with the scaling up of aid and the provision of budget support relate to fiduciary risks, including corruption risks, generally defined as the risks that aid: 1) is not used for the intended purpose; 2) does not achieve value for money and 3) is not properly accounted for. Many factors can contribute to higher fiduciary risks including lack of capacity, skills and knowledge, bureaucratic inefficiency and corruption.

Although the evidence is inconclusive (see next section), it is often assumed that budget support is more vulnerable to corruption than other forms of aid, as it is vulnerable to potential weaknesses in the recipient countries' public finance management systems. In addition, budget support gives partner countries greater discretion in the allocation of aid, providing increased opportunities for rent-seeking and corruption. In countries where domestic accountability mechanisms are weak or inexistent, there is also a substantial risks that aid resources are captured by the political elite, increasing its power relative to other groups in the country and ultimately undermining domestic accountability.

By entrusting countries with the overall responsibility of managing aid, the provision of budget support also implies that donors tend to focus more on policy dialogue with the local authorities, prioritise policy planning over project monitoring and gradually step back from overseeing the actual implementation of development projects and programmes. In Tanzania, for example, this has been identified as one of the factors that contributed to the failure of development partners to detect widespread corruption schemes in a natural resources programme in Tanzania (Jansen, E.G., 2009).

Evidence of linkages between budget support and corruption

In spite of these concerns, there is little empirical data available on how corruption levels affect the development outcomes of budget support and vice versa. The evaluation reports devote very limited attention to the impact of budget support on corruption levels or on how corruption affects the development effectiveness of budget support. The general literature on aid effectiveness and provision of budget support addresses corruption related issues only to a very limited extent, providing scattered and inconclusive evidence on the potential risks and linkages. More in-depth research would be needed to explore and properly assess how budget support may affect forms and levels of corruption.

While corruption has been found to be a serious issue in most countries receiving budget support, there is a broad consensus in the donor community that corruption risks do not outweigh the potential benefits of budget support, as there is no clear evidence that this form of aid is more affected by corruption than other aid modalities. Some evaluation reports even argue that corruption may become more apparent as financial systems are strengthened through the use of budget support and conclude that increased visibility of corruption may reflect higher corruption levels or gains in transparency (USAID, 2004). Case studies of Vietnam and Mozambique based on donor perceptions suggest that project support may be more vulnerable to fraud and corruption than budget support, (Batley et al, 2006 ; Bartholomew et al, 2006). As a result, donors do not tend to consider corruption risks as a prohibitive factor to the provision of budget support.

Other reports and case studies however contradict these perceptions. A USAID evaluation of budget support in Malawi for example identifies political corruption as a major cause of the bad performance of budget support in the country (USAID, 2004). A 2005 CMI paper on budget support and corruption refers to a cross country study conducted by a World Bank economist that concludes that budget support may increase rent seeking behaviours in fractionalised societies, which are characterised by ethnic, religious and regional divisions, as various groups compete to appropriate a share of the common resources (Kolstad, I., 2005).

2 Examples of fiduciary risk assessment frameworks

The development effectiveness of budget support depends on the quality of the recipient country's PFM system. As a result, donor decisions to provide budget support are often based on an evaluation of the quality of the PFM system, of the fiduciary safeguards in place and the likelihood that the funds will be used for the intended purpose. Various assessment tools have been developed to monitor the level of fiduciary risks involved in providing budget support and using country systems for managing aid. The growing trend in this regard is for donors to collaborate and/or use a harmonised framework for assessing fiduciary risks. Examples of such diagnostic tools include:

DFID's fiduciary risks assessments (FRA)

The FRA framework

DIFD has pioneered the use of fiduciary risks assessments as part of its risk mitigation strategy and recommends a thorough evaluation of PFM systems and associated risks, including the risk of corruption. This evaluation is mandatory for all countries and feeds into country programme planning processes. In principle, the agency does not require partner countries to meet a minimum standard of PFM performance to provide budget support. Instead it focuses on the extent to which mechanisms are put in place to mitigate these risks and what evidence can be found for credible programme to drive improvements.

Risk evaluation requires a sound initial assessment of the partner's overall policies and capacities, including PFM systems and accountability framework such as the effectiveness of independent scrutiny of the executive by the legislature, external audits and civil society organisations. The evaluation of the recipient country's PFM system can be based on either the Public Expenditure and Financial Accountability (PEFA) performance framework or a set of 15 benchmarks that have been developed by DFID. DIFD's fiduciary risk assessments typically include:

- an overview of the historical, governance and institutional context,
- an analysis of the performance of the PFM systems,
- the identification of key fiduciary and corruption risks,

- an overview of current initiatives and reforms to address these risks,
- a summary of risks not mitigated by credible reform programmes
- an outline of how fiduciary risks will be monitored over the next period.

DFID guidance suggests a risk rating according to a three part scale- low risk, medium risk and high risk- for each of its 15 benchmarks. No explicit criteria have been published for these ratings.

Based on this assessment, DFID considers balancing fiduciary risks against the potential development benefits and suggests measures to mitigate these risks, including measurable targets and monitoring arrangements. Where fiduciary risks cannot be mitigated satisfactorily, the agency recommends in principle to avoid the provision of direct budget support.

Approaches to managing identified risks can include capacity building initiatives, provision of additional safeguards, requirement for actions to be taken by the recipient country prior to the provision of budget support, as well as agreement on the course of action that will be taken in cases of non performance and joint interventions with other donors.

FRA framework and evaluation of corruption risks

All fiduciary risk assessments must include an evaluation of how the risk of corruption affects the performance of PFM systems and related fiduciary risks, and expect information on whether related reforms (including anti-corruption reforms) represent a credible programme of improvement. The evaluation of corruption risks draws on various sources. These include information from the regular information sources available for evaluating PFM systems, diagnostic material on governance and specific corruption risks, such as transparency International Corruption Perceptions Index (CPI), Transparency International National Integrity System (NIS) country studies, U4 helpdesk answers, World Bank Country Policy and Institutional Assessments (CPIA) and World Bank Institute Governance and Corruption (GAC) diagnostics (see below), etc (DFID, 2005).

World Bank analytical tools

Similarly to DFID and most donors, the World Bank tends to see the improvement of PFM systems as one intended outcome rather than a prerequisite for the provision of budget support. The Bank does not establish minimum PFM performance levels as a precondition for the provision of budget support. Instead, it prefers to focus on the recipient government's commitment to PFM reforms, as well as on evidence of progress overtime. However, the Bank requires an ex-ante assessment of the partner country's PFM and public procurement systems, using tools such as:

- **Public Expenditure Reviews (PERs) or Public Expenditure and Institutional Reviews (PEIRs)** provide a basis for improving the efficiency and efficacy of resource allocation and help countries establish effective and transparent mechanisms to allocate and use public resources for promoting economic growth and poverty reduction. Topics include analysis and projection of revenue flows, budget preparation and execution, the level and composition of public expenditures, inter- and intra-sectoral analysis, and the governance of public sector enterprises. Programmatic PERs/PEIRs involve the preparation of a series of analytical reports/notes over a multi-year period.

- **Country Financial Accountability Assessments (CFAAs)** are a key financial management diagnostic tool designed to describe and assess financial accountability arrangements in a country's public and private sectors. CFAAs support both the exercise of the World Bank's fiduciary responsibilities and the achievement of its development objectives by assessing the strengths and weakness of accountability arrangements and by identifying the risks that these may pose to the use of World Bank funds.

- **Country Procurement Assessment Reports (CPARs)** assess, in practice, the efficiency, transparency, and integrity of a country's entire procurement system. They identify the risks that these systems are vulnerable to and outline action plans to bring procurement in line with internationally accepted best practices.

- **The Country Policy and Institutional Assessment** (CPIA) rates countries against a set of 16 criteria grouped in four clusters: (a) economic management; (b) structural policies; (c) policies for social inclusion and equity; and (d) public sector management and institutions.

- The **IMF's Report on Observance of Standards and Codes** (ROSCs) summarise the extent to which countries observe certain internationally identified areas and associated standards as useful for the operational work of the Fund and the World Bank, including accounting; auditing; anti-money laundering and countering the financing of terrorism (AML/CFT); banking supervision; corporate governance; data dissemination; fiscal transparency; insolvency and creditor rights; insurance supervision; monetary and financial policy transparency; payments systems; and securities regulation.

In addition, to address more specifically corruption risks in its lending operations, the World Bank has also articulated a **Governance and Anticorruption (GAC) Implementation Plan.** This implementation plan establishes processes to ensure a systematic analysis of GAC issues in the design and implementation of Country Assistance Strategies (CAS), as well as in sector work, sector programmes and projects, with the view to systematically addressing GAC impediments to delivering development outcomes. This can include formulating action plans that include a series of measures designed to mitigate GAC risks associated with programmes and activities (World Bank, 2006).

PEFA assessments

Overview of the PEFA PFM Performance Measurement Framework

In recent years, donors have strengthened their collaboration with the objective to develop a common integrated approach to measurement and monitoring progress in PFM performance as well as to establish a platform for dialogue. Within this framework, a PEFA working group supported by the World Bank and the IMF has developed a harmonised framework for assessing budget performance, transparency of the budget formation process, audit reports and other budget related practices known as the **PEFA PFM Measurement framework**. Several donors are already using the PEFA framework's set of indicators to assess the quality of recipient countries' PFM systems. As of May 2009, the PEFA framework had been applied in over 60 countries.

The PEFA PFM Performance Measurement Framework incorporates 31 high level indicators that assess PFM performances against six critical objectives, including the credibility of the budget, comprehensiveness and transparency, policy-based budgeting, accounting, recording and reporting, external scrutiny and audit. Each indicator receives an alphabetic score, which is usually perceived to be relatively difficult to understand and use, especially for cross country comparisons.

Lessons learnt

An analysis of the impact of the PEFA framework was conducted in 2007, based on 12 country case studies (Betley, M., 2008). The study indicates that, although there have been a small number of cases where PEFA assessments have led to direct changes in PFM reform programmes, the positive impact of PEFA assessments has been mainly indirect in most countries. One of the benefits of conducting PEFA assessments has been to provide governments and development partners with a comprehensive overview of PFM's strengths and weaknesses in a single document. The study also suggests that the most effective assessments were those which had active, broad and transparent government participation and were not directly linked to fulfilling a specific donor requirement. Transparency of the assessment process and public disclosure of the results usually led to a more credible outcome, both in terms of findings and government commitment to address areas that required reforms.

While there is no evidence, so far, that ratings have been used directly as a condition or trigger for budget support, various aid agencies use of the performance reports when they make decisions on aid allocations and modalities. Although PEFA assessments provide a comprehensive snapshot of PFM performance, they were not originally intended, however, to be used as an assessment tool of fiduciary risks for the provision of budget support. Some experts even argue that their use for such purposes is likely to affect the quality of the final report, as this creates incentives for governments to influence the scoring and manipulate the ratings (Wilson, R., 2008).

A few shortcomings have also been identified when it comes to using PEFA assessments to evaluate corruption risks more specifically. The PEFA framework does capture some factors that influence the level of corruption such as availability and quality of fiscal information, effectiveness of internal controls and the degree of legislative scrutiny. However, some experts argue that this framework only provides a technical summary of the PFM system with no direct indicator of corruption (Kolstad, I., 2005). They recommend that fiduciary risk assessments informing the decision to provide budget support include an explicit assessment of corruption risks, using indicators of levels of corruption, degree of social fractionalisation, political corruption and sector level corruption. In addition, the report recommends conducting a thorough analysis to evaluate how budget support would affect the underlying causes of corruption, including the country's overall political balance.

3 Common fiduciary risk mitigation strategies

The identification of fiduciary risks associated with the provision of budget support in a given context needs to be followed by the introduction of appropriate fiduciary safeguards to address these risks. DFID's fiduciary risk mitigation strategy distinguishes three major types of mitigation measures that are important to support over different timescales. These measures can include: 1) short term safeguards; 2) mechanisms for monitoring key corruption risks and related reforms in the middle term; and 3) a credible programme of improvement that specifically addresses corruption risks to PFM systems in the longer term.

Short term measures

In countries where corruption risks are particularly high and not effectively addressed in the proposed programme of improvement, some donors introduce shorter term measures to mitigate fiduciary risks. There are a wide variety of measures that can be used to address weakness in PFM systems when providing budget support. A PEFA study of measures used to mitigate risks identified no less than 60 different approaches, including (Brooke, P., 2003).

- **"Earmarking" budget support** to particular purposes, usually priority sectors that contribute to poverty reduction. For example, funds can be linked to certain budget line items to protect these expenditure items such as civil service salaries or pro-poor expenditures.

- Adopting a **"negative" list concept**, such as the World Bank does under certain circumstances, under which budget support funds can not be used for certain expenditures perceived as non pro-poor. While in practice, it has been very difficult to track the use of funds beyond initial receipts of funds, this approach has a clear advantage in mitigating the reputational risk for the donor. In some cases, a "positive list" of expenditures may also be used.

- **Dedicated accounts** may also be established to enable the tracking and accounting of receipts and payments as well as to allow for the auditing of these dedicated accounts.

- Undertaking **Public Expenditure Tracking Surveys** (PETS) to analyse the extent to which budgeted funds actually reach the intended point of local service delivery.

- Requirements to implement **specific controls or new legislation**. This approach, however, may lead to uncoordinated and unrealistic PFM improvement plans.

- Requirement for **timely audited aggregated financial statements** (focusing on budget execution) form the partner country as a condition of budget support. This can help identify how the budget support was spent.

While these short term arrangements may in principle reduce reputational risks, they should be seen as part of a broader risk mitigation strategy, since they do not satisfactorily address the underlying weaknesses of the PFM systems (Shand D., 2005). The above mentioned PEFA study also concludes that the pattern of short term measures of protection currently used by the various development agencies is partial and fragmented, lacking consistency and coordination across donors. Short term piecemeal measures are often prioritised over more sustainable government-led PFM reform programmes that could provide a basis for longer term development of government systems. This is likely to undermine both the realistic sequencing and the effectiveness of PFM reforms.

Medium term measures

Anti-corruption conditions in cooperation agreements

Most donors incorporate explicit anti-corruption clauses and formal commitments to a 'no bribes' policy into their cooperation and financing as an important means for addressing corruption in the political dialogue with partners. Within this framework, corruption and anti-corruption targets and indicators have been explicitly introduced in the performance matrices and conditions linked to the design and implementation of budget support. These targets and indicators mainly refer to a set of legal measures, policy actions and administrative actions to be taken such as the implementation of codes of conduct, anti-corruption programmes and policies. In addition, donors' corruption risk management strategies also include efforts to promote greater transparency, disclosure and civil society participation, as well as to strengthen the monitoring and supervision mechanisms. A U4 expert answer on anti-corruption clauses in cooperation agreements has more specifically focussed on this dimension of corruption risk mitigating strategies and the implementation challenges involved (Chêne, M., 2010).

Appropriate mechanisms also need to be in place for detecting, investigating and sanctioning misuse of development resources. Most donors have put in place supportive investigative mechanisms to investigate and deal with suspected cases of corruption.

In practice, however, there is a broad consensus that the implementation of such clauses has not been particularly effective to date. The scaling up of aid recommended by the Paris Declaration has not been matched by a parallel increase in staff and resources for the management of these funds. As a result donors do not always have the resources and capacity to enforce a zero tolerance policy. With the provision of budget support, the reliance on the development partners' weak internal structures and systems create additional vulnerabilities for the financial management of aid funds.

Monitoring corruption risks and related reforms

It is also important to agree in advance with partner governments on the introduction of effective corruption risks monitoring and supervision mechanisms.

This can include measures aimed at strengthening internal and external controls, as well as reporting, accounting and auditing provisions. The Euroepan Commission (EC), for example, previously requested ex-post audits of its budget support operations which were carried out by an external firm. However, given the high transaction costs and delays involved by such an approach, the EC is gradually moving towards placing greater emphasis on ex-ante assessments of the overall PFM system, while working in collaboration with other donors. The performance of budget support in strengthening control mechanisms is usually perceived as positive: the above mentioned joint evaluation concludes that the provision of budget support has supported greater transparency in public expenditures and higher standards of accounting and reporting.

Further risk mitigation measures can include providing opportunities for independent monitoring of aid by the media, parliament or CSOs and the introduction of effective complaints mechanisms and whistleblower protection. In its **Governance and Anti-Corruption (GAC) strategy** for example, the World Bank recognises that most anti-corruption programmes with a track record of success focus on increasing transparency of decision making and involving beneficiaries in policy making and oversight. As a result, a core principle of the GAC implementation plan is the systematic engagement with a broad range of stakeholders, in order to strengthen transparency, participation, and third-party monitoring of the Bank's operations. However, in practice, in spite of progress made, mechanisms for civil society participation remain weak in many countries and there is a need to strengthen participation through mechanisms of joint management and review.

Long term measures

Short- and medium-term measures cannot substitute for more coherent and longer term approaches that address the underlying causes of corruption and provide a basis for longer term development of government systems. The above mentioned PEFA study recommends prioritising measures that are focused on establishing effective government / donor / stakeholder relations and on building momentum for government reform.

Provision of budget support as an opportunity to strengthen PFM

Budget support itself can be seen as an opportunity to strengthen PFM systems and provide incentives for long term institutional reforms. For highly corrupt environments, for example, an IMF study recommends tying the provision of budget support to institutional reform or actual implementation of these reforms (IDA and IMF, 2003).

It is usually assumed that passing more funds through government systems may result in PFM improvements through the combined effect of capacity development efforts and the provision of technical assistance as well as the agreed upon performance conditions attached to the provision of budget support. In many countries, the provision of budget support resulted in greater attention being given to strengthening PFM systems in recipient countries. In many cases, the provision of budget support is tied to the introduction of fiduciary safeguards such as improving the government's procurement and expenditure management systems.

Early evidence of the effect of budget support on PFM systems is rather encouraging and suggests that it can indeed play a valuable role in strengthening PFM and reducing fiduciary risks. A SIDA evaluation of budget support, for example, found that although little progress had been made in Burkina Faso, Malawi and Mozambique, financial management reform activities had increased with some success in countries such as Uganda, Ghana and possibly Tanzania (Nilson, M., 2004). The joint evaluation of budget support also confirms that budget support has been an effective instrument in strengthening PFM systems, including planning and budgeting processes. It has also helped improve the comprehensiveness and transparency of partner government's PFM.

Support to comprehensive anti-corruption strategies

In addition, donors can support credible anti-corruption strategies that include reforms specifically addressing identified vulnerabilities of the PFM system as part of their longer term risk mitigation strategy. These planned reforms can ideally address specific weaknesses and risks identified by the initial fiduciary risk assessment. They can include transparency and accountability mechanisms such as codes of ethics for government employees, adequate procedures for reporting bribes and protecting whistle blowers, access to administrative review and appeal, as well as anti-corruption legislations. In some cases, for example, donors have provided technical assistance to support anti-corruption and accountability institutions such as audit offices, anti-corruption commissions, parliaments, civil society etc.

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