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Corruption and Development Aid

*by Daniela Mayer**

This paper investigates the aid-corruption nexus. Corruption is a serious issue in many poor countries. It severely hampers economic development. That is why it is often discussed in the context of development assistance which is supposed to be less effective if the recipient country reports a high level of corruption. However, many empirical studies show that aid does not go to low-income-countries with a lower level of corruption because of strategic interests. Nevertheless, using an IV approach we show that aid has a positive impact on corruption.

This paper investigates the relation of corruption and development assistance. The scope of development assistance is not only to reduce poverty, but also to reward good policies and efficient and honest governments. This in particular means a low level of corruption in the receiving countries (Alesina and Weder 1999, p. 3).

Corruption is seen as one of the major problems of the world poorest nations (Nwabuzor 2005, p. 121). Although it was well-known that corruption has a strong negative impact on development this topic has attracted more attention only when rich countries debated the aid assistance's effectiveness at reducing poverty and the misuse of aid provided to poorer countries (Nwabuzor 2005, p. 122).

In the first chapter I am going to examine corruption by first giving a definition what corruption is and then providing some facts about corruption worldwide. The questions, which types of corruption exist, will be asked. The next section focuses on the various reasons for corruption, explaining why especially economically less developed countries are attacked by it. One section gives an answer to the questions why and how corruption influences the economic development in a country. Finally, I will try to provide an answer to the question how corruption can be combated. This is a relevant question especially in the context of development aid, if means provided to developing countries are supposed to lessen corruption in those countries.

The second chapter will first give an answer to the question what development aid is and then give an overview, how development assistance is organized and what the major problems of the organization of development assistance are. Different types of development aid will be briefly explained.

In the third chapter the correlation of corruption and development aid will be investigated. In this context two major questions will be posed: Do low-income countries, which are not corrupt, receive more development aid? Do countries, which are provided development aid, become less corrupt over time? In order to answer these questions the result of various empirical studies will be compared.

CORRUPTION

Corruption can be defined as “the abuse of public trust for private gain” (Todaro and Smith 2003, p. 711). Similarly, Transparency Interna-

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tional defines corruption as “[t]he misuse of public power for private benefits[, which] will include the bribing of public official or embezzlement of public funds” (Nwabuzor 2005, p. 121).

Corruption is a serious problem in many economically less developed countries. The World Bank estimates the amount of money spent on bribery to exceed US\$ 1 trillion a year. For some poor nations, like Nigeria, Kenya and Venezuela bribery accounts up to 12% of the GDP (Nwabuzor 2005, p. 121).

There are various indexes trying to measure corruption, for example the measure compiled from the International Country Risk Guide (ICRG) and the indicator provided by Transparency International, but of course, there can be no perfect estimates of corruption (Alesina and Weder 1999, p. 4, 8, 10).

Which types of corruption exist?

There are different types of corruption. One of them, which is undesirable but does not imply a serious danger to a country’s development, is called “petty corruption”. This type of corruption is the practice of giving bribes to government functionaries before they carry out their service (Nwabuzor 2005, p. 122).

Corruption constitutes a far more relevant problem for the economic development if it relates to “outright diversion of revenues due governments to private pockets” (Nwabuzor 2005, p. 123). There are striking negative examples of this type of corruption in the history of Nigeria and the Democratic Republic of Congo where billions of US\$ were transferred to private accounts abroad. Those occurrences do not endanger only national economies but also the public safety (Nwabuzor 2005, p. 123).

Further serious problems that corruption cause are the possibility of top public servants to despoil very large amounts of money with the help of multinationals or the bribery of public officials by multinationals in order to achieve favorable government contracts and patronage (Nwabuzor 2005, p. 123).

What are reasons for corruption?

Indexes of corruption show that the corruption is much higher in economically less developed countries and many surveys show that it is the world’s poorest nations that have the biggest problems with corruption (Nwabuzor 2005, p. 122, 124). That is why corruption is often explained by poverty. In order not to live in extreme poverty people are more likely willing to accept bribes. However, the need to escape poverty may be able to explain “petty corruption” which is the practice that public functionaries accept money, but it does not reason why individuals that hold high positions are corrupt (Nwabuzor 2005, p. 123, 124). However, Sup’T. Jo. Hampson writes about a “culture of corruption”. Corruption is incremental, because if ethical rules are broken and no punishment occurs, this will result in unethical behavior even in more serious matters (Hampson 1999, p. 121).

Furthermore, Gerald E. Caiden and Naomi J. Caiden do not see corruption as an individual problem, but as a problem with structural causes

and consequences. In systemic corruption violators of the ethic rule are protected and non-violators feel the pressure of their corrupt environment. In such a system those who are charged with revealing corruption do rarely act (Caiden 1977, p. 306, 307).

Not only poverty leads to corrupt practices but also a sudden big growth of wealth (Nwabuzor 2005, p. 124, 125). The example of Nigeria shows that the economy was not ready for the huge amounts of money that could be gained from exporting crude oil and could not ensure a “planned, orderly and judicious use of the money.” (Nwabuzor 2005, p. 125)

One more reason for corruption is the absence or the lack of economic freedom. There is some empirical evidence that those countries which have bad results in the Corruption Perceptions Index, also rank among the least free countries according to the Index of Economic Freedom (Nwabuzor, 2005 p. 125). Corruption in most developing countries is closely linked with “very limited economic freedom and a very weak enforcement of the rule of law.” (Nwabuzor 2005, p. 121)

Why and how does corruption influence economic development?

Corruption is a serious danger for economic growth not only because of multinationals having the opportunity to get very favorable contracts, but also because of privatization programs which really harm the national economy (Nwabuzor 2005, p. 123, 125). Corruption is supposed to have a negative impact on development because it reduces investment. Furthermore corrupt countries tend to invest more money in big projects such as new stadia, airports, etc., because of the possibility of personal profits and spend less money on education (Nwabuzor 2005, p. 129). Corruption leads to an increase in poverty if the governance has difficulties in raising revenues which are needed to ensure the provision of public services. In corrupt countries businesses are driven underground because of the possibility to circumvent formal taxation (Tavares 2003, p. 101). According to Douglass C. North, John Joseph Wallis, Steven B. Webb et al. corruption imposes barriers that limit competition. These barriers have an impact on poor people but are generally tolerated by the elites because they do not essentially harm them (North et al. 2007, p. 31) Corruption is furthermore a serious threat for the national government, if it comes to allegations of fraud of its members (Nwabuzor 2005, p. 123, 130).

How can countries fight corruption?

This question is essential for many developing countries. We can see on the example of Nigeria that many leaders of economically less developed countries have actually understood the importance of combating corruption in their countries (cf. Nwabuzor 2005, p. 121, 130). Still, because of the nature of corruption, it is not easy to fight it even if there is the willingness to do so. One step that should be taken is to empower the rule of law and to make the economy more open. There are suggestions that economies would become more open if the government withdraws from the productive sector. Business barriers should be lowered. Finally, there needs to be more transparency for large payments received by the country. Multinationals, for ex-

ample, could be made to make their monetary transactions through an authorized organization like the International Chamber of Commerce or the Transparency International (Nwabuzor 2005, p. 121). There are some attempts by the United Nations, Organizational Integrity Unit to develop a mechanism in order to combat corruption. Transparency International urges African nations to observe the UN Convention on Corruption and encourages fighting corruption (Nwabuzor 2005 p. 130).

DEVELOPMENT AID

In 2006, there were US\$ 103.6 billion spent on development assistance (excluding private aid). It amounts to over US\$ 2.3 trillion (measured in 2006 \$) over the past 50 years. Because of this huge sum the debate about the effectiveness of past and future development has raised (Easterly and Pfutze 2008, p. 1).

Problems related to development aid

Aid assistance faces various problems, some of them related to the aid agencies which redistribute the means provided for developing countries. There is a lack of transparency about how the money is spent, how high the operating costs of the aid agencies are and how much of the money really arrives in the place where it is needed (Easterly and Pfutze 2008, p. 3). Easterly and Pfutze (2008) conclude that “[i]t is a sad reflection on the aid establishment that knowing where the money goes is still so difficult and that the picture available from partial knowledge remains so disturbing.” (Easterly and Pfutze 2008, p. 23)

There is a big fragmentation of the money spent on development aid. The aid is split “between too many donors, too many countries, and too many sectors for each donor” (Easterly and Pfutze 2008, p. 10). This leads to a raise in the costs of bureaucracy and coordination for both the donors and the recipients (Easterly and Pfutze 2008, p. 3). Development aid is provided either by bilateral aid or multilateral aid from international organizations (Alesina and Weder 1999, p. 3).

Development aid does often not reach the really needy and cannot reduce poverty if it is wasted in inefficient public consumption (Alesina and Weder 1999, p. 3). Lastly, financial aid is not effective if the money goes to corrupt autocrats (Easterly and Pfutze 2008, p. 3). This argument will be of high importance again in the chapter about the development-corruption-nexus.

Types of development assistance

There are different types of development assistance, but the question about efficiency is often raised. One type of development aid is a general budget support for programs or projects (Bjørnskov 2014, p. 11).

It is discussed that aid spent on tied aid, food aid and technical assistance is not entirely efficient (Easterly and Pfutze 2008, p. 3, 17). Tied aid requires a certain percentage to be spent on goods from the donor country. Recipient countries pay a much higher price for the consumption of goods

from the donor country and this type of aid is often rather an export promotion for the donor country. If development aid is provided through food aid it is again the case that agricultural goods provided by the donor country could be purchased at a lower price locally and the aim of this kind of aid is again often an export of agricultural products of the donor country. The goal of technical assistance is to help recipient countries to increase their level of knowledge and their technical know-how. This type of development assistance is very often tied and rather reflects the priorities of the donor than of the recipient country (Easterly and Pfutze 2008, p. 17). However, “[a]mong bilateral aid agencies, the average percentage shares for tied aid, food aid, and technical assistance are 21 percent, 4 percent, and 24 percent, respectively.” (Easterly and Pfutze 2008, p. 17)

Other types of development aid include grants at below market rates and debt forgiveness programs (Alesina and Weder 1999, p. 3).

One type of official development assistance are loans given to the recipient countries that are more favourable than those available on the market, e.g. below the interest rate or with a grace or maturity period longer than that commercially obtainable (Krueger 1986, p. 59).

A different type of development aid are debt forgiveness programs which are often applied because for low income countries the burden of debt is too high relative to the country’s expenditures on health or education. However, the relief itself does not create new resources and so there are reasons to be skeptical towards this form of development assistance. Instead of debt forgiveness new lending and development grants can be a more efficient way to support economic growth (Bird 2003, p. 57).

CORRUPTION AND DEVELOPMENT AID

Do low-income countries, which are not corrupt, receive more development aid?

Opponents of development assistance programs often criticize that money goes to corrupt countries. In contrast, the supporters’ point of view suggests that development aid can be used as a reward for good governments and help to decrease corruption (Alesina and Weder 1999, p. 2). If, in contrary, more aid goes to countries with high levels of corruption this means a failure in the allocation of the provided means (Alesina and Weder 1999, p. 3). That is the reason why the questions about how much money goes to corrupt countries and whether low-income countries, which are not corrupt, receive more development aid are often debated. In this section different studies are compared in order to answer these posed questions. One difficulty in analyzing the impact of development assistance on corruption lies in the fact that a high level of corruption is often associated with poor economic and institutional development (Alesina and Weder 1999, p. 6).

Aid assistance is said to be less effective at reducing poverty when it goes to corrupt dictators, but developing countries, which need help to escape from poverty, are very often corrupt and autocratic (Easterly and Pfutze 2008, p. 13). This is why William Easterly and Tobias Pfutze (2008) raise the question whether the high share of aid going to corrupt autocrats can be explained by the high share of aid going to least developed countries.

However, they find that this is not the case when investigating this issue using “cross-donor correlations of corruption, democracy, and income levels of recipients” (Easterly and Pfutze 2008, p. 15). Their striking results suggest that the share of aid going to corrupt autocrats cannot be explained by aid going to poor countries. Easterly and Pfutze (2008) evaluate aid agencies according to how much of the money goes to low-income countries and how little goes to corrupt or unfree countries. The Nordic Development Fund and the African Development Bank scored best in their evaluation (Easterly and Pfutze 2008, p. 15).

Easterly and Pfutze (2008) furthermore analyzed how much development assistance goes to corrupt countries over time. They use data from the International Country Risk Guide (ISRG) in order to find a proxy for corruption and define a country as being corrupt if it has a score of two points or less on a zero-to-six scale, where zero means extremely corrupt. They find that the share of aid going to corrupt countries has not been constant. They come to the conclusion that aid normally continues to go to the same countries, even if they are getting more corrupt (Easterly and Pfutze 2008, p. 14).

The question, whether corrupt countries receive less development aid was already investigated by Alberto Alesina and Beatrice Weder in 1999. Their answer to the question is “no”. They, on the contrary, conclude that corrupt governments receive more aid and that corruption does not decrease thanks to development assistance (Alesina and Weder 1999, p. 2).

They investigate the share of development aid going to corrupt countries looking separately at bilateral and multilateral aid programs. The idea is that multilateral donors would be less affected by politics and might allocate their means to less corrupt countries (Alesina and Weder 1999, p. 4, 17). Because of the correlation of corruption and poor economic and institutional development they control for other determinants of aid flows, namely the “level of income of recipient countries, their size, economic policies, political system and historic or political links with donors” (Alesina and Weder 1999, p. 11). They can find no evidence that more money goes to less corrupt governments. The data rather suggests the opposite, meaning that more flows go to corrupt governments. They find that Scandinavian development aid addresses less corrupt countries, while U.S. programs seem to rather support corrupt governments, even though the U.S. prefer democratic to dictatorial systems. In total they do not find any significant difference between bilateral and multilateral aid in terms of sensitivity to corruption. When examining multilateral aid they find that there is no correlation of the level of corruption and the inflow in recipient countries. These findings show that development assistance is not used to reward “good governance” and to combat corruption doing so. Only private aid programs seem to pay some attention to the level of corruption in the recipient country (Alesina and Weder 1999, p. 4).

For further investigations they use three different ways to “scale” the amount of money a country receives. The first one is the percentage of aid in relation to GDP, the second is aid per capita or aid over population and the third one is aid over government spending (Alesina and Weder 1999, p. 12). The latter is especially interesting when investigating corruption, because “high corruption may imply that domestically raised public resources

are low and a higher fraction of public resources are covered by foreign aid” (Alesina and Weder 1999, p. 14). They find some empirical evidence that “, *ceteris paribus*, a country that is more corrupt by one standard deviation from the mean, receives about 9 percentage points of aid over government expenditures.” (Alesina and Weder 1999, p. 14)

To summarize the general result, all three measures of the amount of foreign aid show that corrupt governments are not discriminated in the allocation of development assistance (Alesina and Weder 1999, p. 13).

These results are in line with the investigation of Alberto Alesina and David Dollar (2000). When they approach their research question who gives development aid to whom and why they examine the allocation of development aid and find that political and strategic consideration still play the more important role than economic needs and policy performance (Alesina and Dollar, 2000, p. 33). This underlines the prior result of Alesina and Weder (1999) that good institutions are not rewarded and given more development assistance. It is notable that the Nordic countries seem to pay the most attention to the quality of institutions in the recipient country. Other countries, like for example France, give development aid to former colonies. The development assistance policy of the United States is determined by strategic interests in the Middle East (Alesina and Dollar, 2000, p. 33, 34).

Paul Collier and David Dollar (2002) as well emphasize the importance of strategic interests in the provision of development aid. They find that development assistance is inefficient, because the reduction of poverty is not maximized due to the inefficient allocation. They suggest that policy makers in donor countries should set different priorities, because of the large number of empirical studies that show that development assistance does not influence the quality of policy in the recipient countries (Collier and Dollar 2000, p. 1475, 1476).

Finally, Joseph Hanlon investigates the influence of development assistance in the case of Mozambique. He follows the criticism of other economic researchers that corruption is actually rewarded because donors have different interests as the combat of corruption, such as a quick market-friendly policy change and having a good example of development on the African continent (Hanlon 2004, p. 760).

Do countries, which are provided by development aid, become less corrupt over time?

In theory development can have a positive or a negative impact on corruption. The amount of foreign aid provided can lead to a decrease of corruption if foreign aid has a conditionality effect meaning that foreign aid imposes rules and conditions on the recipient country in order to limit the discretion of local officials. The decrease can also be due to the liquidity effect. If salaries for public employees get higher, it lowers their supply of corruption (Tavares 2003, p. 104). On the other hand, development assistance can lead to an increase because of interest groups fighting for the available resources (Alesina and Weder 1999, p. 3). The answer whether indeed an increase or a decrease in the level of corruption is associated with development aid has to be investigated empirically. In the following, several studies examining this question will be compared.

In order to survey the question, whether corruption decreases thanks to foreign aid or not, Alesina and Weder (1999) investigate the change in corruption and the change in received aid. They do not conclude that development assistance leads to a decrease in the level of corruption. In contrary, more aid goes to countries that become more corrupt in the subsequent periods (Alesina and Weder 1999, p. 5, 19).

Stephen Knack investigated the effect of development assistance on the quality of government. This is measured by indices of bureaucratic quality, corruption and the rule of law. Therefore the quality-of-governance index provided by ICRG is used. In line with Alesina and Weder (1999), his OLS estimation shows that development aid has a negative impact on the quality of government, thus on corruption. An increase in aid relative to GNP of 15 percentage points reduces the ICRG index by 1 point (Knack 2001, p. 310, 314, 317).

However, Deborah A. Bräutigam and Stephen Knack (2004) argue that the negative influence of development assistance on the quality of government might have diminished after 1990. This is because the crucial importance of combating corruption has been realized and because of the United States not needing to give aid to geopolitically important but corrupt autocratic countries after the end of the cold war. They split their data into two periods, 1982-90 and 1990-1997. The results show that development assistance has a negative impact on the quality of government in both subsamples, but after 1990 it is not statistically significant any more. Nevertheless, there is no statistically significant difference between the two periods meaning that there is no conclusive evidence that development aid harmed the quality of government more before the 1990s (Bräutigam and Knack 2004, p. 275)

In contradiction to the findings of Alesina and Weder (1999) and Knack (2001), José Tavares (2003) finds that development aid leads to a decrease in the level of corruption. He uses geographical and cultural distance to the donor country as an instrumental variable to assess causality (Tavares 2003, p. 99). Tavares (2003) examines the impact of inflow due to development assistance on the level of corruption in the recipient country. The instrument he uses for the GDP share of foreign aid inflows are “indicators of the recipient country’s geographical and cultural proximity to OECD donor countries interacted with the latter’s aid outflows” (Tavares 2003, p. 99). In his research he estimates the impact of development aid on corruption among non-OECD countries using the International Country Risk Guide indicator of corruption. Five-year averages of GDP per capita are computed and used as a control variable, because if good institutions are a normal good, an increase in GDP per capita would lead to a decrease in the level of corruption. Other control variables are political rights, ethno-linguistic fractionalization, a dummy variable whether the country is an oil exporter, total population, the share on public expenditures on GDP and a dummy variable whether the country was a former colony. Then the 11 largest OECD countries (according to 1990 GDP) are selected and for each pair of developing country and OECD country four variables that capture geographical and cultural proximity are computed, namely geographic distance and dummy variables for common land border, same majority religion and same official language (Tavares 2003, p. 102). The basic idea behind is that development

countries with a close tie to an OECD country, which increases its expenditures in foreign assistance, would experience an increase in development aid. A regression of aid inflows and those four variables is run. These estimates are used in a second stage regression in order to explain corruption. From these coefficients the causal effect of development aid on corruption can then be inferred (Tavares 2003, p. 102). The estimation shows that an increase in aid inflows of 1% of GDP leads to a decrease in the level of corruption of 0.2 on a scale from one to ten. This means that aid is negatively related to corruption. The explanation for these results differing from other studies mentioned above is that “the coefficient on actual aid flows is biased down by reverse causation” (Tavares 2003, p. 103). This means that even though aid helps to diminish corruption the results are biased because of less corrupt countries receiving less aid. Instrumenting for aid inflows the findings suggest that development assistance leads to a decrease in corruption (Tavares 2003, p. 103). The findings are robust to the inclusion of control variables of different determinants of corruption and robust to heteroscedasticity and the exclusion of outliers (Tavares 2003, p. 99, 103). The estimation furthermore confirms the hypothesis that higher GDP leads to a decrease in corruption. Oil exports on the other hand increase corruption in a country (Tavares 2003, p. 103, 104).

In consonance with Tavares (2003), Simplicio A. Asongu (2012) finds some evidence that there is a positive effect of aid on corruption. With data from 52 African countries in the period of 1996-2010, the effect of foreign aid on corruption in Africa is investigated using two panel estimation techniques (Asongu 2012, pp. 2-3). The explaining variable used is the Net Official Development Assistance (NODA); openness (trade), autocracy and democracy are controlled for. The Instrumental variables include legal-origins, income-levels and religious dominations (Asongu 2012, p.4). This method is applied in order to deal with the endogeneity problem that development assistance affects the quality of institutions and is partially dependent on the quality of institutions of the recipient country (Asongu 2012, p. 4). The Hausman test confirms the presence of endogeneity and Two Stage Least Squares (TSLS) Instrumental Variables (IV) are used (Asongu 2012, p. 6). A dynamic panel GMM broadly confirms the results of the first estimation and gives some evidence that there is a positive impact of aid on corruption (Asongu 2012, pp. 7, 9).

CONCLUSION

There is a broad literature focusing on corruption and development. Corruption is a serious problem in many of the world's poorest nations (Nwabuzor 2005, p. 121). It severely hampers economic development. This is the reason why the scope of development assistance should not only be to reduce poverty but also to combat corruption. This can be achieved if development assistance rewards a lower level of corruption. However, studies investigating the correlation of the amount of foreign aid and the level of corruption do not always find that aid agencies discriminate corrupt countries. Alesina and Weder (1999) come to the conclusion that countries with a high level of corruption do not get less foreign support. Easterly and Pfutze (2008) find that aid continues to go to the same countries without concern of

the level of corruption of recipient countries. This is in line with the results of Alesina and Dollar (2000), Collier and Dollar (2002) and Hanlon (2004) who all emphasize the importance of strategic interests in the allocation of development assistance. However, the question, if low income countries, which are not corrupt, receive more development aid, can be rejected. The investigations of Alesina and Weder (1999), Easterly and Pfutze (2008), Alesina and Dollar (2000) and Collier and Dollar (2002) all come to the conclusion that corrupt countries are not discriminated. This means that there are other (and more important) reasons for development assistance than to fight corruption and strategic interests play an important role in the allocation of development assistance as it is stated in Hanlon (2004).

The amount of foreign aid provided can lead to a decrease of corruption due to higher salaries for public employees which lower their supply of corruption or because of foreign aid imposing some conditions on the recipient country (Tavares 2003, p. 104). On the other hand, it can lead to an increase because of interest groups fighting for the available resources (Alesina and Weder 1999, p. 3). With respect to the question if development aid helps countries to combat corruption, the empirical studies lead to diverging conclusions countries, which are provided by development aid, become less corrupt over time, the empirical studies come to diverging conclusions. Knack (2001) estimates an OLS regression and finds a negative impact of aid on corruption; Alesina and Weder (1999) also do not conclude that development assistance leads to a decrease in the level of corruption in the recipient country. However, Bräutigam and Knack (2004) find suggestive evidence that the negative impact of corruption on the quality of governance was stronger before 1990. Those empirical studies which use regression analyses to investigate this question come to similar results. Knack (2001) finds some evidence that there is a negative impact of aid on corruption. Bräutigam and Knack (2004) come to the same conclusion with the addition that the negative impact has been weaker after 1990. Alesina and Weder (1999) do also not find a positive impact of aid on corruption. In contradiction to those studies mentioned, there are two more recent studies which use an Instrumental Variable approach. Both studies, Tavares (2003) and Asongu (2012), find a positive effect of aid on corruption. Tavares (2003) argues that the results of an OLS regression are biased because of less corrupt countries receiving less aid. This leads to the conclusion that it is necessary to apply instrumental variables to answer the question about the effect of aid on corruption and that there is indeed some evidence, that development aid helps countries to combat it.

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