CHAPTER 3: AID DONOR APPROACHES TO INSTITUTIONAL DEVELOPMENT

3.0 Introduction

Donor organisation's understanding of development effectiveness has evolved since post-World War II reconstruction aid, and seems set to change further. It has shifted from a view that inadequate capital was the core problem in developing countries to an approach centred on improving standards of internal governance, and its link with poverty alleviation. A broad definition of governance is used in this thesis, as defined by Fox et al (2005:v);

> the way in which any social unit – from the smallest community to society itself - organises itself politically to exercise power to effect change. Such changes refer to a range of public actions including the making and implementation of public policy, allocation and management of public resources and the identification and resolution of public problems.

In recent years, debates on governance have shifted to the question of *how* donors can influence the institutional environment in developing countries, drawing on anthropology, sociology and the institutional economics traditions. Central to this view is the idea that societal institutions need to be more robust in order to facilitate better governance, and the right incentives need to exist to help institutions evolve in a positive direction. Advocates of development aid argue that it can provide incentives to enhance performance if well designed. Aid also has the potential to trigger poor behaviour through interventions that create incentives leading to poor decision-making by governments (Collier and Dollar, 2004; Fukuyama, 2004: 39-40, Easterly, 2001, 101-137). For instance, Van de Walle (2005:38) has argued that in many low-income states aid has often simultaneously propped up states, whilst keeping them weak. Chapter 3 seeks to explore and analyse emerging aid donor approaches to supporting development in countries characterised by weak governance and poorly formed institutions.

The chapter itself is divided into three main sections. Section 3.1 briefly explores the evolution of donor approaches to international development aid as well as empirical cross-country findings on aid effectiveness. Section 3.2 examines newer approaches to aid, with a focus on institutional change in so-called 'fragile states', which includes about 46 countries (Branchflower et al, 2004:24-27). Section 3.3 will conclude the chapter by reviewing early policy recommendations on aid instruments for institutional building in fragile states.

3.1 Development Aid Effectiveness

Economists' understanding of the determinants of economic growth has had a strong influence on the nature of development aid over time. However, in an attempt to locate the missing ingredients of growth in developing countries, Easterly (2001) argued that historically the underlying economic determinants of development aid have been flawed. He draws upon a number of cross-country empirical studies (Lucas, 1990; Romer, 1994; Pritchett, 1997) to conclude that capital stock (based on the Harrod/Domar model), low levels of technology (Solow residual) and low human capital (education levels) does not sufficiently explain the low (or negative) growth in developing countries, and thus these factors should not be conceived as the panacea for development aid. Easterly (2001) and others (Olson, 2000; Easterly and Levine, 2001; Van de Walle, 2001; Rodrik, 2002; Kaufmann and Kraay, 2002; Rodrik, 2006) have thus all concluded based on cross-country studies that 'institutions matter' and it is the quality of a country's institutions and *how* the country can collectively organise itself to take advantage of capital, technology, education opportunities and even economic policy advice that matter most to growth. In other words, market and government failure impose the greatest constraints on economic development. Most recently, Rodrik (2006) has dubbed this new focus on institutions as the 'augmented

Washington-consensus'.

Last decade, drawing on economic theory and aid evaluations, the broader aid policy community came to new conclusions on development effectiveness (World Bank, 1997). This was that aid was most effective in promoting growth in good policy and institutional environments, and was least effective where a country's policies and institutions were weak (Dollar and Pritchett, 1998; Collier and Dollar, 2004). In the 1990's, this emerging policy consensus contributed to an increase in aid to countries with good policy environments (McGillivray, 2004) and, more generally, to aid interventions focused on improving governance of the state.

Although the donor community seems to have reached a broad consensus in the late 1990's that the quality of the institutional environment is key to prospects for growth, there was little consensus on *how* donors could best support the development of 'good governance' and 'good institutions' through development aid programs. It is at this point that the development policy debate turned from *what* the missing ingredients were in developing countries, to a debate primarily about *how* aid was delivered, and *how* different forms of aid could best, over short, medium and longer time periods, ultimately deliver better development outcomes (see Bossyt, 2001; DFID, 2004c; World Bank, 1997; World Bank, 2005b).

In retrospect, it is undeniable that first generation governance interventions which aimed to contribute to institution building were misguided. These programs were traditionally focused on the state and premised on push, or supply-based, strategies. They aimed to build the capacity of state institutions through the supply of technical advisers and training programs designed to build human capacity, and hardware improve technical systems (i.e information technology) (see Grindle, 1997). First generation governance programs were typically delivered in project modality in parallel to the partner government's systems where procurement, financial management and recruitment worked through donor's systems set up for that project. Aid was normally directed to central agencies (i.e. treasury, planning and finance functions) and formal law and justice agencies (such as police and court system). These projects typically aimed to improve policies, planning and technical skills, rather than addressing the broad organisational constraints that undermined previous development policies. Project designs further assumed that good policies and training (i.e. technical skills) would provide a fix to governance problems in a relatively short timeframe, usually, three to five years.

However, evaluations of donor projects aimed at delivering governance established that changing the quality of governance was much more complex than technical assistance, training programs and new technologies (Morgan, 2002; Levy, 2004; Grindle, 1997). A recent World Bank report entitled *Economic Growth in the 1990's Learning from a Decade of Reform* (2005) concluded that where government leadership was strong (e.g. Uganda) governance interventions were successful. However, governance programs did not work where they either sought to achieve 'big bang' fundamental reform relatively quickly (i.e. structural adjustment programs), or were ad hoc governance reform interventions. This report further suggests that 'big bang' approaches were ineffective because of their inconsistency with the capacity and political preferences of the country, and ad hoc programs failed because they tended to pay lip service to reform (2005:24, 301-303).

It is now thought that effectively addressing governance requires structural and behavioral change and needs local ownership, leadership and a significant change in the way that donors design and deliver aid (Dollar and Pritchett, 1998:22). Most critically, donors need to find better ways to influence the internal processes of change to maximise the sustainable impact on growth and development in developing countries (Unsworth, 2003:15). In short, aid needs to create incentives for good performance in key political, economic and service delivery institutions in developing countries to have a positive long-term impact

(Olstrom et al, 2002; Easterly, 2001:290-291).

The OECD Network on Governance and Capacity is sponsoring research on different approaches to development, centred on endogenous processes of capacity and performance. Boesen et al (2002) have proposed a framework for categorising aid interventions as set out in Table 2.

Table 2: A Methodology for Aid Interventions

Different ways of supporting capacity development		
	Predominately functional approach	***Predominately political approach***
Interventions focusing on internal system elements (push strategy)	***Functional-push*** Strengthening formal organisational structures, systems and skills, e.g. through training, organisational change processes, infrastructure support	***Political-push*** Seeking to change internal dynamics, e.g. by supporting reformers, changing internal competitive pressures, providing performance-based benefits to key staff, etc.
Interventions focusing on external stakeholders and factors (pull strategy)	***Functional- pull*** Strengthening the capacity of the organisation to deal with functional external actors	***Political-pull*** Seeking to change external pressures or supporting, building or maintaining external stakeholders.

Source: Bolger, Mandie-Filer and Hauck (2005) adapted from Boesen at el (2002)

This framework seeks to explain the difference between push–strategies (i.e. supply-driven by donor) from pull-strategies (i.e. demand-driven by stakeholders) to developing capacity and institutional development. Push-strategies are focused solely on enhancing the capability of the target organisation, and people within this organisation (i.e. training courses). Pull-strategies are concerned with influencing change through strengthening actors in the broader system that the organisation operates within (i.e. rewarding well-performing Departments or provinces with additional financing). On the horizontal axis, this framework uses examples to explain the difference between a functional and a political approach. A functional approach assumes that the core constraint to development is skills and knowledge, and thus aims to transfer these core skills. Essentially a political approach, drawn from the comparative-institutional tradition, seeks to use motivational frameworks to induce actor-driven change. The majority of aid program interventions seeking to influence the quality of governance to date have employed functional-push strategies. The institutional economics literature, which stresses the importance of endogenous change processes suggests that aid donors need to increasingly adopt *political push* and *pull* strategies in order to have more impact.

The donor community has also learnt that project aid delivered through parallel systems have high transaction costs on governments (see DFID, 2004c; AusAID, 2005f:20). Parallel program delivery can divert recipient governments' attention away from their own policy and management functions to the management and monitoring of donor programs. Over the past five years, efforts to improve aid effectiveness have triggered a move by many donors away from project aid towards a focus on alignment and partnership models based on working in line with the national budgeting and planning processes at the organisational, sectoral or central government level. The Department for International Development (DFID) in the UK, the leading donor in general budget support, is now providing over 15 percent of its total aid budget in this form (Lawson et al, 2003:19). Budget support and other forms of program-based aid (for example, sectorwide approaches) set up under the right conditions, and with a public expenditure management focus, have been found to be more effective in changing work practices and organisational capacity, compared to other modalities of aid (Fukuyama, 2004:88; Lawson et al, 2003; DFID, 2004c; Bossuyt, 2001). Although considered most likely to lead to sustainable development outcomes, budget support and other forms of on-budget program-based aid rely on strong partner country leadership, good capacity and manageable levels of corruption. As many developing countries do not have these attributes, forms of budget support is not a panacea in itself. In addition, budget support in some environments may also raise transaction costs for recipient governments.

Typically, large amounts of technical assistance (TA) have accompanied governance programs. TA is the provision of human capital, usually considered to be technical experts, and most often foreign personnel. In the 1990's, over $US 170 billion was directed at TA to improving government capacity (Grindle, 2002:21). TA has been a central part of all aid modalities, both in projects and alongside budget support as a means of substituting for weak capacity in financial management, policy advice, implementation and monitoring within the aid recipient's systems. Despite large amounts of TA being delivered with good intentions to build capacity, evaluations of TA have found that it can displace local skills and weaken the bureaucracy if the program if premised on a functional-push strategy, and thus does not take into account misaligned organisational incentives and political dysfunctionality (Morgan, 2002:7-10; AusAID, 2005f:19; Van de Walle, 2005:71; Baser and Morgan, 2001:27-30). Organisational evaluations have commonly found that the overwhelming weaknesses in organisations are due to poor management (i.e. poor leadership, high absenteeism, non-merit based promotion) and political market failure (i.e. patronage systems), rather than a technical nature (see AusAID, 2003b). Furthermore, reform of public service organisations requires political and broader societal support which has often been absent from large-scale reform programs (Levy, 2004:11). More recent evaluations (Chauvet and Collier, 2004:13) have suggested that large amounts of TA delivered outside a 'home-grown' reform agenda, where key internal actors do not have internal incentives to improve their performance, will not lead to significant gains in organisational effectiveness and be unsuccessful at leveraging reform at the country-level.

The focus of aid-financed governance interventions has generally been on the state; in particular on key central and service delivery agencies at the national level. However, there has been increased recognition that political market failure requires a deeper and more diverse response. As a consequence donors should pay increased attention to political systems (i.e. electoral reform), the strength and density of civil society organisations and networks (i.e. media, non-government organisations) and the role of the private sector and think-tanks to induce and support change. Until the recent past, these organisations outside the sphere of the public sector typically received less attention from donors as agents of governance reform. It can be argued that a donor consensus has now emerged, premised on the foundation that donors need to strengthen civil society alongside the state to help create the conditions for government-civil society dialogue, demand for change and reform of political accountability as a necessary conduit to any policy and economic reforms being attempted with government institutions (Unsworth, 2003; Fukuyama, 2004; LICUS Task Force, 2002; Leader and Colenso, 2005; Grindle, 2002). Despite this argument for strengthening civil society, it must be understood that weak government is normally closely correlated with weak civil society and thus donors should acknowledge that this process is also incremental and long-term in nature (Van de Walle, 2005:26).

At this point, while we are considering the *what* and *how* of aid, it is worth acknowledging there are various alternative views to the conventional wisdom that 'institutions rule' propagated by the World Bank (see also Rodrik, 2004; Kaufmann and Kraay, 2003). While there seems to be consensus that institutional quality is important, there are competing views on causality in the development process - economic growth, stronger institutions or other factors (Jütting, 2003:19-21). For example, Sachs (2003) has challenged the view that institutions are the primary driver of growth and instead argues that geography is the major determinant. Similarly, Przeworski (2003), Khan (2002) and Chang (2001) have all provided arguments that the reverse causation exists, and in fact claim that economic growth and development produce institutional reform.

Accordingly, if these views are taken as convention wisdom, development aid should first focus on providing opportunities for growth, not state-focused institutional reforms. Despite the claim that growth comes first, it is difficult to think of a country where there has been sustained growth where there has not been a relatively robust set of existing institutions (either informal or formal) to promulgate growth. Asian countries are often cited as possible examples, but most of the successful Asian countries have a long history of relatively robust informal institutions that facilitate economic exchange and social capital. On the other hand, many Sub-Saharan and Pacific nations had few institutions that existed beyond clan-based societies prior to colonialisation.

Where does the conventional wisdom on development policy leave us today? First, we seem to have broad agreement that 'institutions matter' to development outcomes. Second, there is growing consensus that genuine partnerships (rather than aid giver, aid recipient hierarchies) are critical to influencing the quality of institutions over the long-term (DAC, 2005b). As a result, budget support and other forms of on-budget program-based aid, when political will and a reasonable level of state capacity exists, can positively influence growth and development outcomes. However, this policy conclusion assumes that a country's institutions already function well enough for the aid community to support its policies directly, be coordinated by the government and for aid to be delivered through its systems. In countries where political will for development is lacking, state capacity is chronically weak, and kleptocratic elites control the state, these aid effectiveness principles have been deemed to have limited success (Radelet, 2005:16-22). It is for this group of countries, most recently labeled as fragile states, that further reflection on development effectiveness is required.

Fragile states are home to around 29 percent of the global population living in absolute poverty. If we exclude India and China, these states contain 58 percent of the population living in absolute poverty (Branchflower et al, 2004:7). The impact of fragile states on global poverty and international security means these states are assuming an increasingly prominent place in the development literature. Some interesting new thinking is emerging on the nature of 'institutional failure' and *how* donors can influence the internal processes of change, particularly in relation to fragile states. This body of literature is explored in section 3.2.

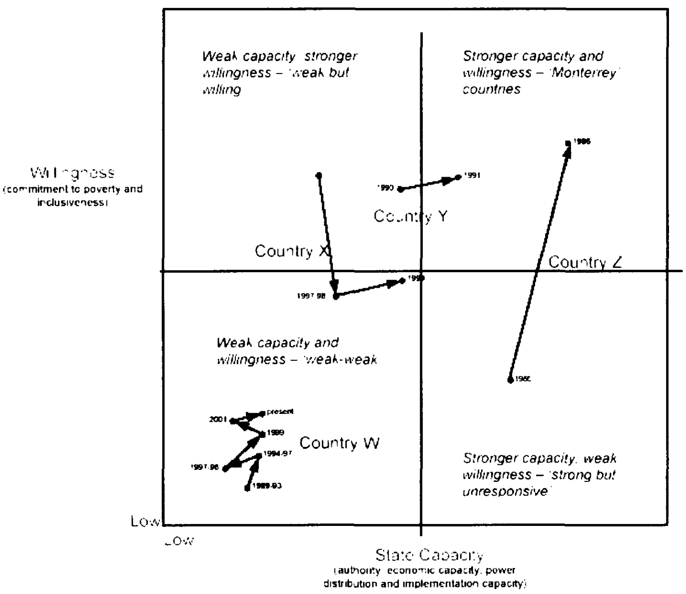
3.2 Institutional Change in Fragile States: The New Aid Agenda

3.2.1 Defining Fragile States

It is useful to begin by defining 'fragile states', otherwise known in the development policy literature as 'difficult partnerships' (OECD Development Assistance Committee (DAC)), 'difficult environments' (Department for International Development (DFID)), 'poor performers' (World Bank, Overseas Development Institute) or 'Low-Income Countries Under Stress' (LICUS) (World Bank). Fragile states are generally defined as countries "characterised by very weak policies, institutions and governance" (LICUS Task Force, 2002:1) where the state, to varying degrees, is unable to effectively undertake its core or minimal functions (Moreno-Torres and Anderson, 2004:7). Minimal functions, as set out in chapter 2, Table 1, could be best characterised as the successful provision of "adequate public goods to their people, including safety and security, public institutions, economic management and basic social services" (Moreno-Torres and Anderson, 2004:7). In addition, the World Bank would include a measure of "citizens influence on government" as a core indicator for catergorising fragile states (LICUS Task Force, 2002:3) and the DAC would include measures of poor relations between donors and state because the key elements of ownership and commitment to poverty reduction are missing (DAC, 2001:8). In sum, fragile states have limited development capacity in key political, economic and social institutions and/or limited political willingness to make commitments to poverty reduction for all their citizens (Moreno-Torres and Anderson, 2004:26-27). Three out of four fragile states are affected by ongoing armed conflict (World Bank, 2005d). In other words, these states exhibit government failure as described in the economic literature in chapter 2.

In spite of this attempt to define fragile states, there appears to be little consensus in the literature on a 'hard and fast' definition. Rather, there is a continuum of characteristics that are useful for analytical purposes to inform aid policy (LICUS Task Force, 2002:iii). The fragile state paradigm commonly encapsulates a number of state typologies ranging from state collapse (e.g. Somalia) to those characterised by neo-patrimonial politics (e.g. Zimbabwe) (Moreno-Torres and Anderson, 2004:5-6; Branchflower et al, 2004:24-27). A state's characteristics are not static – and where a state's characteristics are changing they are not necessarily moving on a positive and linear path. A state's capacity to undertake its minimal functions, as set out in Chapter 2, Table 1, may in fact move up and down the effectiveness scale over time. Moreno-Torres and Anderson (2004:19) have used a state 'willingness and capacity' topology to illustrate the dynamic attributes of a fragile state as illustrated in Figure 2 below.

Figure 2: A Topology of State Capacity and Willingness



Source: Moreno-Torres and Anderson (2004:19)

Consistent with its focus on countries with weak institutions the World Bank has acknowledged that developing countries are often 'overloaded' with externally driven reform agendas too big and numerous for its bureaucracies to handle (World Bank, 1997; LICUS Taskforce, 2002). Fukuyama (2004:6-21) argues that modern states pursuing economic development should concentrate on consolidating their strength (i.e. based on its capacity to enforce its rules and implement its policies) rather than on increasing the scope of its functions. For example, it is more important for a fragile state to concentrate its scarce resources on improving macroeconomic management and delivery of health services, than on regulatory reforms and redistribution programs. This finding has had an impact on the nature of donor-financed reform programs, and the sequencing of economic reforms. For example, post-Asian crisis there seems to be a much better understanding of the costs of fast financial liberalisation if sound institutions do not underpin reform initiatives (Fukuyama, 2004: 17-21)

A number of donors have sought to reexamine their development policies to better inform the nature of their interventions in fragile states. The World Bank, the DAC and the UK's DFID in particular have led this process of developing new analytical frameworks to change development aid policy and programming. These approaches are centred on the weaknesses of institutions in developing countries and, to differing degrees, on the potential role of aid in influencing institutional change. These approaches are now examined in turn.

3.2.2 World Bank: Low-Income Countries Under Stress (LICUS) Initiative

In 2002, the World Bank released a report on its proposed new approach to dealing with LICUS. Its' approach was based on the premise that in countries with weak policy and institutional capacity, the Bank's standard *modus operandi* was increasingly less effective in influencing development outcomes. The Bank concluded that excessive lending to fragile states "worsens corruption, accumulates indebtedness" (LICUS Taskforce, 2002:10), and makes it difficult for aid to encourage positive reform as the loan is used to maintain and entrench the status quo (Easterly, 2001:101-137; Collier and Dollar, 2004). The LICUS approach makes a number of suggestions to guide the nature of interventions in core LICUS, or fragile states. These policy suggestions are centred on the premise that donor interventions provide important negative and positive incentives for institutional reform in developing countries, and in fragile states, donors need to be aware of a slightly different set of good practice norms. The LICUS approach is intended to be a learning-based and therefore continuously evolving framework. The following explanation of the approach seeks to capture the essence of the current LICUS literature.

First, the LICUS approach proposes a policy for international donors of 'engaging differently' (LICUS Task Force, 2002:iv). It suggests that in core LICUS countries large loans will be counter-productive because the state does not have the capacity or the will to use finance for 'pro-poor' growth, and implement the structural adjustment packages that are often associated with loans. However, the approach strongly advocates that donors should not withdraw from operating in these environments – simply operate in a different way. The LICUS literature proposes that disengagement (i.e. the exit of donors and donor programs from the country) could accelerate the slide into even deeper poverty, instability and violent conflict in fragile state environments, and would be counterproductive to development (LICUS Task Force, 2002:iii). It points to a number of organisational constraints within the Bank's own institutional arrangements that in the past have encouraged its staff to offer loans to bad government or, on the other hand, totally disengage with governments where loans are not in place. This focus on how donors' own internal incentives can do harm in developing countries is significant. Furthermore, the framework suggests there are four different categories of LICUS, which require differentiated approaches. The four categories include, governance deteriorating; prolonged political crisis; post-conflict transitions and gradual improvers. The World Bank (2005e) has commented that this paradigm has tended to be overly focused on post-conflict transition countries, at the expense of other LICUS types.

Second, LICUS proposes the identification of a small number of simple and achievable basic reforms ('zero generation'), feasible in sociopolitical terms, that will build on local initiatives, demonstrate that positive change is possible, and build the consistency for reform in and outside government (LICUS Task Force, 2002:v). This approach is consistent with broader emerging consensus in development policy. For example, Grindle (2002) has argued that the large number of reforms the World Bank is promoting through the 'good governance agenda' (over 150 characteristics) is problematic and impossible for developing countries to achieve. This argument is amplified in fragile states where by definition they have weak institutions and are often fragmented politically and socially. Instead, Grindle (2002:1-2) proposes that the donor community should be aiming for 'good enough governance' which she defines as "a condition of the minimally acceptable government performance and civil society engagement that does not hinder economic and political development". Grindle (2002:6) voices her concern that these states, with limited financial, human, institutional and political capacity to fulfill the conventional good governance agenda, will consume all their political capital on reforms that have little impact on development. In promoting this approach Grindle (2002:21) proposes that donors should assist countries to better assess capabilities, target fewer changes, and "work towards good enough rather than ideal conditions of governance".

The LICUS approach further suggests that local actors, rather than standard 'headquarters-designed' reform packages, need to be used to identify the social and policy constraints and develop appropriate policy responses. It is important to stress that the LICUS approach proposes that in these environments it is essential that aid interventions are developed in-country, and that external donors are well coordinated to reduce rent-seeking opportunities.

Third, the LICUS approach suggests that donors need to be extremely well coordinated in the delivery of essential services to the populations in fragile states. If services are not being delivered, the literature suggests that the fragility of the state will increase (LICUS Task Force, 2002:25; Berry et al, 2004:9-12). As a way of preventing further instability, LICUS strongly advocates donor partnerships with functioning non-government organisations and the private sector to deliver services and promote reform. It also promotes the creation and funding of Independent Service Organisations (ISO) to take-over some of the core minimal service delivery functions of the state, where the state is not operating effectively (LICUS Task Force, 2002:25). The creation of ISOs seems to be inconsistent with development evaluations that advocate the avoidance of parallel systems and potential disincentives to reform by propping up the state.

3.2.3 Development Assistance Committee (DAC): Learning and Advisory Approach (LAP) on Difficult Partnerships

The DAC-driven LAP process attempts to advocate a broad set of basic principles to guide donor interventions in fragile states. The process draws on the World Bank's LICUS framework, but is broader, in an effort to get across-the-board agreement from development agencies and their whole-of-government partners that inevitably are engaged in fragile states due to international security concerns. The LAP also seeks input from fragile states themselves. LICUS to date has been much more narrowly focused on a development bank's operations.

The LAP's '*Ten Core Principles for Good International Engagement in Fragile States'* (DAC, 2005a) reinforce the general principles for aid effectiveness contained in the *Paris Declaration on Aid Effectiveness* (DAC, 2005b). These principles are centred on the idea that primary responsibility for development in fragile states is the core responsibility of its leaders and people, and the international community's core responsibility is to "help national reformers build legitimate, effective and resilient state institutions" (DAC, 2005b)

First, the LAP discusses the similarities and differences between best-practice aid effectiveness and so-called best practices to fragile states. The core difference between the *Paris Declaration* and the LAP is that in fragile states the task of supporting national reform is more complex, challenging and long-term in nature. Unlike LICUS, the LAP puts alignment and partnership principles at the centre of the framework. However, consistent with LICUS it advocates that where government is weak to the point that political will and capacity is lacking the LAP suggests that donors need to support civil society, the private sector, and the parts of the government that are working, and also continue to support service delivery. The LAP recognises that this change process takes time and may in fact be intergenerational (DAC, 2001:4)

Second, again consistent with the *Paris Declaration,* the LAP cautions against undermining national institutions, even where they are weak, by totally bypassing national systems (i.e. budget processes or state service delivery mechanisms). This approach differs in theory but perhaps not in practice from LICUS, which advocates possible support for alternative avenues (i.e. ISOs) for service delivery where the state's machinery has broken down to the point that services cannot be delivered in partnership with it (LICUS Task Force, 2002:25). It is difficult to determine the point at which services have broken down in fragile states to the point that it is in the long-term interests of its citizens for donors to work outside the state. The LAP has not sought to specify the point on the 'fragile-to-collapsed' state continuum where this strategy is recommended.

Third, the LAP stresses the importance of partnerships and the need for practical cooperation between donors. In contrast to LICUS, the LAP broadens the principle of partnership to focus on policy coherence between international actors and between these actors' own whole-of-government policies and interventions (i.e. foreign policy, trade, defence, aid) in relation to fragile states. This raises the important question of coherence between military-led interventions in response to state-building, such as the recent US-led intervention into Iraq, and development policy.

In sum, the LAP is broader than LICUS, but generally its principles are similar. Despite small differences that take account of the limited capacity and will of the state, the LAP agenda is consistent with generally agreed international best practice for aid effectiveness. Its only real point of departure is the recognition by LAP that aid needs to be significantly more focused on working outside of government to help create momentum for societal change and reform, and that this process is extremely long-term.

3.2.4 UK's Department for International Development: Drivers of Change (DofC)

DFID's policy *Why we need to work more effectively in fragile states (2005)* follows a comparable rationale to LICUS and LAP, and draws out similar policy prescriptions. However, DFID's policy places a greater emphasis on understanding the political economy, institutional frameworks (i.e. informal system such as patronage), and the role of that political incentives play in state failure. It employs a tool - which it has coined the 'Drivers of Change' (DofC) approach - to apply to aid strategies. DFID began trialing this tool in 2002, and although initially this process did not specifically focus on fragile states, it has been primarily applied to these states due to the problems they present for the international community. Through this process, DFID has sought to reexamine the effectiveness of its aid interventions by better understanding the underlying dynamics of local politics (both systems and actors) and the role of both formal and informal institutions in the internal change processes of countries (DFID, 2004d:1-2).

DFID country programs have been required to undertake a country analysis that assesses the interaction between the interests of the key actors (i.e. political elite, public servants, civil society), structural features of the economy (i.e. history, urbanisation, regional demographics) and institutions (formal and informal behaviours/rules). Explicit to this analytical approach is identifying internal and external agents of change, how power impacts on top-down political will for reform and the role that 'pro-poor' groups have in the change process to create demand and momentum for change over the medium term (DFID, 2004d:1-2).

This approach is essentially a comparative institutionalist inspired country analysis which differs from a more traditional country analysis in a number of ways. First, DofC encourages an explicit focus on change processes as a way of informing *how* the donor (as an external agent) may influence reform, rather than *what* is required to change and *what* types of activities should be delivered. Second, the approach recognises that change processes are dynamic and that the situation will be ever changing, requiring regular reexamining of the context and flexible programming. Third, the approach encourages analysts to look explicitly at the incentives of agents within the institutions involved in the change process (including aid donors themselves). In common with the Bank, DFID has recognised that to implement DofC they also need to shift their own operational incentives and structures to ensure that the findings could be implemented. Finally, by accepting that donors are an important external force generating both positive and negative impacts on decisions and change processes, country programs were required to critically assess the overall impact of aid (DFID, 2004d). This approach links closely with the economics literature on institutional change discussed in section 2.4.

Nigeria - considered a 'core-fragile state' (Branchflower, 2004:27) - is one of the countries where the DofC approach has been piloted. The analysis concluded that DFID's past strategies and programs did not identify the deep-seated constraints blocking pro-poor change (Heymans and Pycroft, 2004:11). The DofC approach has led DFID to focus specifically on the political economy of Nigeria's oil revenues and the disincentive it creates for pro-poor change. Its conclusions highlight the scale of the entrenched interests of the corrupt political elite, and the need for donors to work with a broad range of stakeholders (including civil society, the media, private sector and government) to have any transformational impact on poverty in Nigeria.

In practical terms, the LICUS, LAP and DofC approaches offer donors a new menu of considerations in analysing the nature of their engagement with developing country partners and its people. These frameworks better focus donors on *how* they can and cannot influence change in developing countries. In policy terms they encourage donors to be more conscious of the potential for interventions to do harm by creating negative incentives.

3.2.5 United States Development Assistance: Fragile States and the Millennium Challenge Account

USAID's *Fragile States Strategy* (2005) draws on the lessons and policy findings from LICUS, LAP and DFID. However, it is much more clearly linked to the United State's strategic interests, and the prevention of failed states and crises. For example, it has formed a 'Fragile States Council' and is developing 'Fragile State Quick Response Teams' to guide the US response to fragility crises (2005: 9-10). Compared to the approaches outlined earlier, the US strategy has less focus on indigenous institutions, incentive-based approaches and the political economy of aid.

Paradoxically, despite the US's weak focus on long-term institution building and incentive-based approaches in its *Fragile States Strategy*, it is the first donor government to seriously attempt to employ a pull-based aid approach, based on rewarding good governance, through the Millennium Challenge Account (MCA). Essentially, the MCA provides budget support to low-income countries that score above the medium on core governance indicators, including, ruling justly, investing in people, ensuring economic freedoms, and on controlling corruption (Radelet, 2005:4-5). Interestingly, the first 16 countries that qualified for 2005, included two countries widely considered, on the basis of their governance credentials, to be fragile states – Vanuatu and Georgia (for lists of countries see DFID, 2005:27-28 and Radelet, 2005:5). It is not clear how the approach advocated by the fragile states literature – more narrowly focused aid, less large loans and grants – can be reconciled with the MCA in the case of Vanuatu and Georgia.

3.2.6 Other Approaches to Fragile States

A number of other bilateral donor agencies have also been reviewing their policies and practices in relation to fragile states. One approach worth discussing is the Australian Government led approach to Solomon Islands through the Regional Assistance Mission to Solomon Islands (RAMSI). This approach provides a good illustration of the complexities that donors face and the difficulties of working with a fragile state, where it's government institutions have lost their legitimacy.

From 1999 to 2003, when Solomon Islands started to show signs of major instability, donors attempted a number of interventions to influence its core functions - mostly focused on law and order, service delivery and governance reform. It was argued that these interventions had minimal impact on Solomon Islands and were insufficient to halt the downwards spiral of governance and address the root causes of instability (Wainwright, 2003:490-491). Acting on an invitation from the Prime Minister, international donors through RAMSI, effectively took over many of the core functions of state- law and order, economic, and service delivery. In theoretical terms, this type of intervention could be considered outside the principles advocated by the LAP approach, and is certainly inconsistent with Fukuyama's (2004:88) advice that to influence institutional capacity international donors "need to avoid the temptation to speed up the process [of development] by running the factory themselves".

Based on its success to date in Solomon Islands, Australia has argued that in fragile states, where there is limited political will and capacity, turning the country around may require large scale and 'hands-on' international assistance to deal with the collapsed parts of the state and to assist it to return to a positive development path (AusAID, 2005:1). Three years into its operation, it is still too early to tell whether the gains achieved by RAMSI will be sustainable over the medium to long-term once the international presence is phased out (see Dinnen, 2004). In the long run, its success or otherwise, will depend on whether it has provided the right environment to encourage the evolution of Solomon Islands' political, economic and social institutions. The political turmoil following the April 2006 election suggests that there is long way yet to go before Solomon Island's core institutions are robust enough to sustain themselves.

A recent report to the Australian Government on aid policy directions seeks to reconcile these inconsistencies between local ownership, and local demand, and donors focus on large scale state-building in fragile states. This report (see AusAID, 2005f:19, 39) argues that technical assistance to 'provide' capacity (capacity substitution) over the long-term, rather than 'build' capacity may be necessary in fragile environments to rebuild the state. On the other hand, Dinnen (2004:6) questions whether state-building interventions in states which are in the nascent stages of formation, are at risk of merely rebuilding the apparatus of state that has previously collapsed, thus inviting further failure down the track. He suggests that without more focus on nation-building and supporting the evolution of governance systems so they are more relevant to its people, interventions in fragile states are unlikely to be effective over the long-term.

In the post-cold war world, the United Nations and other donor agencies have been involved in a number of other 'state-building' exercises around the world. Many of these exercises have followed military interventions to impose peace and security. They have generally sought to reestablish order, often from an initial position of chaos, or substantially change or transplant the institutions operating within the state (for instance, the US led intervention in Iraq). In general, there seems to be a consensus that prevention of state collapse, in order to avoid expensive state-building exercises, is an important international objective, and a good reason for the new focus on fragile states (Chauvet and Collier, 2004:2-4). However, it is difficult to reconcile the LAP, LICUS and DofC approaches focused on incremental institutional change in fragile states, with the practice of large scale state-building that promotes rapid institutional change. Arguably these two approaches are at sharp odds. This inconsistency is further discussed in chapter 4, section 4.2.

3.3 Aid to Fragile States: A Clearer Agenda for the Future?

The aid policy communities' recent focus on institutions, institutional change and the role of incentives in the development process is important for improving the quality of aid to developing countries. Analysis of what works and what does not work is nonetheless in its formative stages, and much remains to be learned.

It is worth drawing attention to DFID's analytical work on the effectiveness of aid instruments in fragile states. DFID has been specifically concerned with investigating *how* the donor community can reconcile aid effectiveness principles with the prevalent conditions of weak capacity and limited political will for pro-poor change that typifies fragile states. Put bluntly, what is the next best (or least worst) strategy for effecting positive change in fragile states? Sub-section 3.3.1 discusses emerging donor thinking on aid modalities in fragile state environments. Sub-section 3.3.2 concludes the chapter with some final observations on the fragile states paradigm.

3.3.1 Aid Modalities

Most aid policy frameworks continue to advocate that where good governance does not exist that donors should work in project modality (for example, see Radelet, 2005). However, Bossuyt (2001:6-8) argues that even under these conditions project-based aid tends to undermine institutional development. As an example, DFID's policy guidelines stipulate that where conditions are right, general budget support is the aid instrument most likely to support a partnership between donor and developing country to achieve poverty reduction and support the capacity of the state (DFID, 2004c:1). But the extent to which DFID can implement partner-led approaches like budget support depends on whether the state has "a stable political system, basic competence in economic management, some level of pro-poor commitment by the political leadership and sufficient administrative capacity to formulate and implement programs" through which aid is likely to have a development impact (Moreno-Torres and Anderson, 2004:10-11; DFID, 2004b:4-5). To reconcile this gap in the policy literature between partnership principles and the prevailing conditions in fragile states, Leader and Colenso (2005:44-47) have undertaken research for DFID. Their research specifically questions the effectiveness of the dichotomy between standard 'approved' models for fragile states (i.e. project aid and through NGOs) and the 'unapproved' models (i.e. budget support and program aid) that has generally been applied across developing countries.

Berry et al (2004) and Leader and Colenso (2005) have suggested some basic principles which add to the LAP policy suggestions outlined in Section 3.2.3. First, service delivery is important in fragile states as both an entry point for reducing potential instability and conflict, and as an instrument for intergenerational change and governance reform (Berry et al, 2004:15-16). In states where there is a lack of 'pro-poor' political will for development effectiveness, donors should identify alternative entry points in the central government and/or at the decentralised level where some political will for change exists. Second, donors' should focus less on the choice of aid instruments (i.e. project verses program aid) and more on objectives and context to inform aid interventions in fragile states (Leader and Colenso, 2005:48-53). Third, Leader and Colenso (2005:54) advocate that donors need to first consider aid effectiveness, then aid modalities, not the other way around. They further recognise that program aid will carry risks due to low state effectiveness, but that approaches which are pooled, multi-donor, involve state and non-state actors, and shadow align state systems (rather than work through) could contribute to more to aid effectiveness in fragile state environments than interventions without these features. Finally, Leader and Colenso (2005:16) argue it is important for donors to promote approaches that are based on a generally agreed framework which can give coherence between security, aid and diplomatic interventions (for example, peace agreements, joint assessments or national budget). Given the complexity of aid delivery in fragile states, this paradigm acknowledges that aid sometimes may have to aim for the 'least worst' interventions. In short, keep delivering aid to the point where the aggregate long-term benefits outweigh the aggregate long-term costs. It is recognised that this policy conclusion is not optimal, but has less negative consequences then total disengagement (Leader and Colenso, 2005:43).

3.3.2 Concluding Observations on the Fragile State Paradigm

The fragile states paradigm seems to have usefully added to the aid effectiveness literature. Most critically, it has encouraged the broader donor community to consider different approaches for different types of states, and brought dilemmas around aid interventions in poor governance environments into sharper focus. The literature has adopted a normative lens, and strongly suggests that fragile states will turnaround over time, with aid interventions being an important influence on this turnaround. For instance, Chauvet and Collier (2004:13) using cross country regression analysis calculate that once a state becomes fragile on average it will remain fragile for 56 years. However, this analysis incorporated states that had strong indigenous institutions prior to statehood, and therefore the finding may not be appropriately applied to all states without these pre-state features.

Despite the knowledge and learning derived from the fragile state paradigm, there is a possibility that it has become 'over-popularised' and linked to strategic objectives, and lost its potential focus on the centrality of institutions to development. As a consequence, it may not lead to an improvement in actual aid effectiveness on the ground. DFID's 'Drivers of Change' approach and the analysis emerging from the OECD Network on Governance and Capacity, which sit to the side of the mainstream fragile state literature, has greater potential to draw out worthwhile policy lessons for aid in fragile states. These approaches place analysis of the existing governance systems, including informal systems, at the centre, and seek to design interventions around endogenous change. It is suggested that these approaches should be the focal point of the fragile state paradigm. Further assessment and experimentation with *political-pull* strategies (or incentive-based approaches) to aid interventions would also significantly enhance the literature, and arguably the quality of aid interventions.

The purpose of this chapter has been to outline the evolution of development aid approaches. It has described donor policy and thinking on institutional change and explored this analysis through an examination of the fragile state literature. However, despite a degree of apparent excitement within this new found area of aid policy, there are a number of remaining challenges and questions in relation to the utility and coherence of the fragile state paradigm. Chapter 4 examines how the broader institutional economic literature and donor policies and practice intersect, and discusses the practical constraints to implementation of effective aid.