CHAPTER 4: INTEGRATING THEORY, POLICY AND IMPLEMENTATION

4.0 Introduction

The earlier discussion of the salient economic literature assists in appreciating why certain policy and practices have emerged (or been submerged) in development aid. Continuing with the theme that 'the quality of institutions matter', and are critical for development, this chapter seeks to integrate the core findings from the review of the institutional economics literature in chapter 2 and of development aid approaches in chapter 3. It analyses the links between the theory, policy and implementation of institutional change and attempts to draw conclusions on development aid effectiveness for application to fragile states.

The chapter itself is divided into five main sections. Section 4.1 explores the similarities and differences between the institutional economics literature, development policy and aid approaches in practice. Section 4.2 applies the non-market (government) failure models to the aid sector in order to assess its potential costs and benefits. Section 4.3 discusses the 'consensual view' on best practice in implementing reform within fragile states. The chapter ends with brief concluding remarks in section 4.4.

4.1 From Theory to Practice

In general, development policy and approaches to aid have been built on the foundations of the economic literature. Hence, when the conventional 'economic wisdom' prescribed the 'capital gap' to be the solution for development, capital transfers were the core focus of aid. More recently, new growth theory and institutional paradigms have come to dominate the economic literature. Not surprisingly, development aid paradigms have typically followed suit, albeit with a time lag. For example, the centrality of institutions to economic growth and development reemerged in the economics literature in the early 1990's, but not in development policy until the publication of the *World Bank Development Report 1997*. However, the importance of institutions did not take centre stage more broadly in the development literature until around 2000. In this respect, the World Bank, which has substantial resources dedicated to research, analysis and operational functions, has an important bridging role between theory and policy.

There are a number of core findings from within the institutional economics literature which have now become important strands of best practice development policy. These strands are now discussed in turn.

4.1.1 Theory to Policy

The first and most critical shift in development policy, which draws on the economic institutions literature, is understanding that aid interventions that work with processes of change are a more effective strategy for influencing change than interventions that seek to achieve optimal 'end points' of good governance (Unsworth, 2003; Taschereau and Bolger, 2005). For example, in a fragile state where there is limited political will for reform, the first step for donors to work towards eliminating corruption may be to support research organisations and other non-state actors to increase information flows about state expenditure, rather than partnering with the state on optimal policies for eliminating corruption. Change within societies mostly occurs endogenously (North, 1990) and external donors have to work with, and build upon, indigenous efforts at forging reform to have any hope of influencing countries to move towards a more positive institutional path. Hence, to influence sustainable reform in developing countries it means collaborating with both formal (i.e. the state) and informal institutions (i.e. communities that operate under an informal set of rules) to shift the overall incentive structures in society (Jütting, 2003:30).

However, the economic institutions literature explored in chapter 2 strongly suggests that external interventions cannot transform failed or failed states if an endogenous change process across broader society has not taken place. The literature further concludes that discontinuous fundamental institutional change is rare, thereby arguing that predominately exogenous approaches to state-building will be ineffective once the imposed authority is taken away. This effect will be compounded if there had not been sufficient endogenisation of new institutional practices, both within and outside the state. This framework raises questions about the theoretical feasibility of large state-building exercises in failed states that do not allow sufficient time for embedding public administration and new structures of political governance. For example, many of the UN-led peace-keeping operations in Africa have been unsuccessful at reestablishing effective states, in particular in the area of restoring a credible political system (for example, Liberia, Democratic Republic of Congo, Sudan).

The second strand where there is broad consistency between the economic literature and emerging development policy relates to time horizons for institutional change. The institutional literature concludes that timeframes for change are slow, and it will take considerable time for embedded institutions, such as culture and traditions, to change. Development approaches are increasingly recognising that five year programs are unlikely to induce sustainable change and much longer time horizons are required to achieve reform in developing countries (see Grindle, 2002:15; Chauvet and Collier, 2004:13).

Third, the economic literature concludes that to change incentive structures on a sustained basis, the new institutional architecture must have reasonably broad-based societal support to be sustained. Development policy now accepts that 'top-down' reforms, are doomed to failure if there are no reciprocal and accountable relationships between agents (voters) and principals (local leaders, members of parliament) at both the local and national levels. This means finding ways to build capacities amongst communities and at the leadership level to help remove constraints in the political market. This conventional wisdom now seems to be accepted as a necessary component of any reform program and is growing in focus for donors (for instance, see AusAID, 2005f; DFID, 2005).

Despite this emerging congruency between the institutional economics literature and donor policies on fragile states, there appears to be a growing internal inconsistency within the fragile states paradigm itself. At the soft end of the continuum, the primary focus is on slow, endogenous institutional change, pull-strategies and harm avoidance (for example, DFID's DofC approach outlined in sub-section 3.2.4). At the harder end, influenced by a desire to prevent total state collapse, the central aim of a large scale exogenous re-institutionalisation of the state (for instance, the RAMSI intervention outlined in sub-section 3.2.6). At this point, the fragile state literature does not seem to have reconciled these often contradictory soft and hard approaches. This tension is further discussed in sub-section 4.1.2 on implementation.

4.1.2 Implementation

On the difficult question of policy implementation, the gap between economic theory and policy to practice looms wide, and is seemingly more difficult to bridge. Merging good policy with practice is particularly challenging where economic concepts are fuzzy, multifaceted and intangible, such as the notion of 'institutions'. Major factors effecting implementation are now discussed in turn.

Aid is Political: The first major constraint to more effective development aid is that it is delivered within a geopolitical context. The bulk of foreign aid is through bilateral channels and tends to follow national interest (Alesina and Dollar, 1998). National interests thus both influence the geographic spread of aid and the objectives of aid. Aid cannot be separated from domestic politics and the need for the government of the day to be seen to be protecting its strategic and economic interests, often through using aid as a foreign policy tool.

Although a set of principles has been agreed upon by the DAC on aid to fragile states, in practice there is no consensus between the aid, foreign policy and defence communities, and even between some aid agencies, on 'how to deal' with fragile states. Major tensions exist in getting the right balance between the soft end of the continuum - which stresses 'good' partnership principles and the use of aid modalities that build upon the country's own institutions and systems - and the harder end, based on externally driven state-building exercises that refashion the core functions of the state. These gaps between theoretical best practice and actual practice are most glaring where there is a concern about the negative flow-on effects of a fragile state to the international community (i.e. Afghanistan following September 11). Where national interest agendas, and therefore the influence of Defence, Foreign Affairs, Trade and Treasury on aid programming and policy are high, aid is more likely to seek to achieve fundamental and relatively quick outcomes based on exogenous inputs. There are good reasons why a donor state, faced with close to a collapsed state on its doorstep, will opt for a hard end short-term solution to restoring the institutions of state, rather than adopting a long-term approach that on average requires at least 56 years to take effect (Chauvert and Collier, 2004:13). Under these circumstances, few of the core strands of the consensus between the economic literature and development policy are likely to be observed and applied.

It is, however, impossible for the negative effects of aid to be completely eliminated. For instance, if the 'Drivers of Change' approach was applied in its pure form, the international community would not be delivering any aid, and in practice would amount to disengagement. Consistent with Leader and Colenso's (2005:43) advice, where all interventions create some negative incentives for reform, the donor community needs to find the 'least worst' interventions to minimise the negative effects of aid. In this context, the role of development aid agencies, which outwardly seem committed to ‘best practice’, is to ameliorate these interests and deliver aid programs that are as effective as possible within its national interest framework. Regardless of this assumed intention for best practice, in a domestic whole-of-government context, development aid agencies generally hold little power and influence on the resulting intervention. For example, many aid agencies report to Ministries for Foreign Affairs, and are rarely represented by a separate Cabinet Minister solely responsible for aid. The UK is an exception, with a Cabinet Minister for International Development. This may be one reason DFID is perceived to have been able to adopt more innovative approaches. In the United States, large parts of their aid budget dealing with state fragility is increasingly administered by newly-created agencies controlled by the State Department.

Consensus between the development aid community and the security sector on approaches to state-building may only come about if evidence emerges that one view is more successful, or the other is deemed to have failed. A review of the security sector state failure literature also suggests that within the security community there is less focus on how to prevent state failure and more focus on predicting the transition from fragile to failed or collapsed states (see for instance, State Failure Taskforce, 2000; Carment, 2003). It is feasible that over time, in the post-Cold War world, as development, foreign affairs and defence agencies are forced to work together in state-building exercises valuable lessons may emerge.

Local Analysis: Second, aid will only produce tangible benefits for fragile states if country-based analysis of social and political institutions is genuinely used to influence programming. In this sense DFID’s attempts to reassess and redesign a number of its major programs based on analysis of local institutions goes furthest amongst the new donor approaches to addressing the acute challenges in fragile states. Nonetheless, it will be many years before we know whether a more explicit focus on endogenous institutional change, based on the principles of partnership and alignment, can in fact produce positive outcomes. In this sense, the proposition that externally supported constituencies for change can eventually turn a country around might be theoretical.

Adopting a process, rather than output, based framework for influencing reform is challenging because it represents a shift in the way donors should think about change. In particular, it means having a thorough understanding of the social, political and economic dynamics in the recipient country, and implementing context-specific programs. Within aid bureaucracies, this means increased decentralisation and flexibility in donor programming, and a more limited role for donor headquarters in setting reform policies and program directions. This process of decentralisation within donor agencies themselves is occurring (for example, within the World Bank, AusAID and DFID), but will take more time to take root. However, in some instances, usually relating to major policy and programs decisions, interventions are designed almost solely in the headquarters. By way of example, Australia's Enhanced Cooperation Program (ECP) in Papua New Guinea (originally planned to be $800 million over 5 years, and thus Australia's largest single activity), which has placed Australian officers in line positions within key institutions of the Government of Papua New Guinea, was primarily driven and designed in Canberra.

There is also a real risk that donor agencies will take on the consensus views on fragile states, simplify them and then apply them generally to all countries without undertaking the primary analysis that is fundamental to institutional change processes. Policy prescriptions around fragile states may also be victim to the application of standard solutions. Even the conventional wisdom on the minimal functions of the state, based on its capacity (see Figure 1, chapter 2), erroneously prescribes desirable outcomes. In reality, it is inherently challenging for fragile states to strip back to 'minimalist functions' when the state already performs a broad range of 'activist functions' that provide rent-seeking opportunities and fuel the predatory and kleptocratic nature of the state. It may be impossible to reduce the functions of the state where there is limited political pressure for change. In fact, Levy (2004:1) contends in his review of state-building in Africa, that knowing the "desired end point is only moderately helpful in discovering the path from institutional weakness to stronger capacity". In this sense, if the policy community promotes a desired 'end point' for fragile states, based on the notion of 'minimal functions', there is a risk that the change process itself is not applied organically. Prescribing these outputs risks application of *function-push* strategies focused on reform of the state, rather than *political-pull* strategies that seek to achieve change by using incentives.

Donor Agency Incentives: A third major inconsistency between the economic literature and development aid practice relates to the incentives within aid agencies themselves. Easterly (2001) argues that the way in which aid bureaucracies are required to function for domestic purposes (for example, by demonstrating outputs for domestic public consumption) does not allow for aid to be delivered effectively. Some aid agencies (i.e. the Swedish International Development Agency) have acknowledged that their own internal procedures create perverse incentives to deliver particular programs in certain ways and sought to address them (Ostrom et al, 2002). Perverse incentives within aid agencies can actually contribute to weakening development outcomes in recipient countries by providing too much aid which may help to maintain the status quo in poorly governed countries. Easterly (2001:101-120) points out that many states have received numerous loans that have not led to any reform or growth, and simply supported corrupt regimes. For example, from 1980 to 1994, 12 countries each received over 15 adjustment loans which led to a median level growth of zero in these countries (Easterly, 2001:115). Furthermore, the donor community's limited understanding of capacity constraints in fragile states has complicated the agenda by donors insisting on too many concurrent reforms that are simultaneously impossible for these states to achieve, and may actually undermine the objectives of donors.

Focus on the State: Fourth, there is an over-tendency in practice for aid donors to focus interventions on the hard end of the fragile state continuum which focuses on strengthening key state organisations. Hence, the collective action problems that underline the political, economic and social institutions that make up the foundation of the state receive less attention. In a review of international development cooperation Ostrom et al (2002) pinpoint the lack of collective action in many developing countries as the key issue that aid donors need to influence at all levels of society. Changing processes of collective action are hard to observe and ultimately require long-term changes in attributes, such as the quality of leadership, social capital, and voter behaviour. However, to get effective collective action, local capacities and networks need to be encouraged and nurtured, and can take generations to develop. Taschereau and Bolger (2005: 27-29) argue there is much potential in adopting a 'systems approach' to development cooperation, where aid is primarily focused on cultivating informal networks and local capacities, although admit that it is premature to apply the type of approach to the public sector. This aspect of the aid development literature requires further development.

4.1.3 Critique of the Paradigm

To conclude, this sub-section offers a critique of the fragile state paradigm. First, it is worthwhile stressing that the fragile states agenda is the latest 'new fad' to hit the generally-trend driven development community. A *Google* internet search of fragile states and development cooperation brings up over two million hits over the 2005 year. Aid donors and policy institutes appear to be tripping over each other to demonstrate that their work in this area is groundbreaking. It is useful to consider whether these new approaches add to our understanding, or is the fragile states paradigm simply a case of 'old wine in new bottles?' Certainly some interventions, labeled as being a 'fragile state approach', start off with the premise that the country is fragile and its institutions are weak, but then have not necessarily applied the suggested contextual processes, and examination of local incentive structures, to influence programming. One example of this approach is Australia's ECP in Papua New Guinea which is considered to be an example of a fragile state intervention.

A series of case studies commissioned by the World Bank (2005c) identified examples of aid-financed interventions that have achieved good results in transforming governance and service delivery in fragile states. However, in most cases, programs were deemed successful on the basis that they contributed to stability and service delivery, tending towards the hard end of the fragile state continuum. Success was not assessed on whether aid-financed programs had a sustained impact on the quality of institutions, and that the negative incentives of aid programs were effectively minimised. It is interesting that three out of four of these selected case studies have operated in parallel to government, were off-budget, and have been delivered at the local level rather than the central level.

In some cases, programs that are claiming to be LICUS or LAP consistent appear to be a case of being re-packaged in order for the donor agency to lay its claim that they are operating in accordance with best practice. Nevertheless, given that institutional change is a long-term process, it will be many years before the donor community can realistically assess the effectiveness of programs and whether aid has in fact acted as positive (or negative) catalyst for constructive institutional change. The key point is that recent evaluations of aid programs in fragile states have not yet sufficiently focused on, and evaluated, the incentive structures of aid interventions.

Finally, it is useful to consider broader issues emerging from the operationalisation of fragile state paradigm. This paradigm is useful for development practitioners in order to inform diagnostics and approaches to countries. However, Australia's recent experience in Papua New Guinea demonstrates it can be extremely counterproductive to donor agency's objectives if this development paradigm is used to 'label' countries, and act as the basis for prescribing certain responses. In the context of discussing aid policy and programming with other countries, it is more useful to seek to come to a joint diagnosis of the problems and how these problems can be overcome, than to engage under the banner of fragile states. Generally, bureaucrats in fragile states are well aware their state is fragmented. Reinforcing this reality through discussing future aid directions, using a fragile state label, is likely to be counterproductive, and may create a gulf in political relations and the foundation for frank dialogue on aid effectiveness.

4.2 An Economic Model for Assessing Aid Interventions

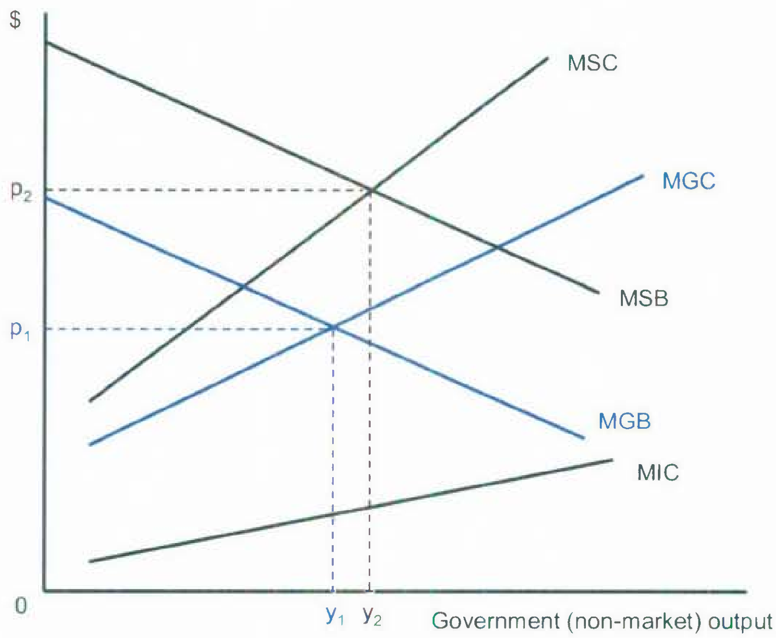
Non-market failure (government) failure is a primary concern of both the institutional economics literature discussed in chapter 2 and the aid donor approaches in fragile states explored in chapter 3. This Section seeks to draw them together by applying models of government failure to aid interventions using a marginal social costs (MSC) and marginal social benefits (MSB) diagrammatic framework. This analysis draws on Wolf's modeling of government failure initially explored in chapter 2, sub-section 2.3.1.

In this series of diagrams, MSC is determined by a country's institutional and governance characteristics, and thus the targeted institutions capacity to absorb and effectively use additional aid. Therefore, the higher the quality of governance (i.e. lower rate of non-market failure), the less MSC will shift outwards from marginal government costs curve (MCG). As the quality of governance deteriorates, the MSC will shift out further from the MCG. Similarly, better quality donor aid interventions will cause further the MSB curve to shift out from the marginal government benefits curve (MGB); the worse the quality of the aid intervention, the smaller the shift of the MSB.

First, assume a situation that excludes foreign aid from the analysis. The cost of government provision of goods and services to the public is represented by

MGC, and the benefits represented by MGB. It is assumed, drawing on the government failure literature, that because of the characteristics of non-market demand and supply (as outlined in section 2.3.1) government intervention creates a level of failure (referred to from hereinafter in as 'negative internalities') which results in a MSC curve that sit above the MGC. This analysis also incorporates 'positive internalities' that results in the MSB curve sitting above the MGB curve. The marginal internal cost (MIC) curve represented in the government sector is analogous to the marginal external costs in the market sector (Fleming, 2006). Marginal internal benefits (MIB) are captured implicitly as the vertical distance between MSB and MGB curves. In Figure 3 below, a small increase in government expenditure, from what the government considers to be optimal output (y_1 to y_2), results in a large increase in price from p_1 to p_2.

Figure 3: Government Sector with Negative and Positive Internalities



Source: Fleming (2006:3)

Next assume a fragile state environment, with foreign aid expenditure, adopting a long-run time horizon. In fragile states, government failures are higher because state institutions are weaker, and subject to higher negative internalities. The provision of aid, also a non-market good within country X, can further exacerbate government negative internalities. The MIC for aid is determined by a combination of the below outlined effects;

High transaction costs on government – Transaction costs are the government resources spent on managing foreign aid (i.e. meeting with project teams etc). These costs can crowd out government resources and divert government from focusing on its core tasks (Easterly, 2002:52). Transaction costs include the opportunity cost of pursuing aid-pushed reforms on the bureaucracy and political system.

Fiscal effects – In a poor governance environment, aid is normally highly fungible by freeing up government resources for non-priority government consumption, and fuelling opportunities for patronage and corruption (Easterly, 2001:101-120; Harford and Klein, 2005:3). If poorly managed, aid can also lead to inflation and boom-bust cycles in government spending.

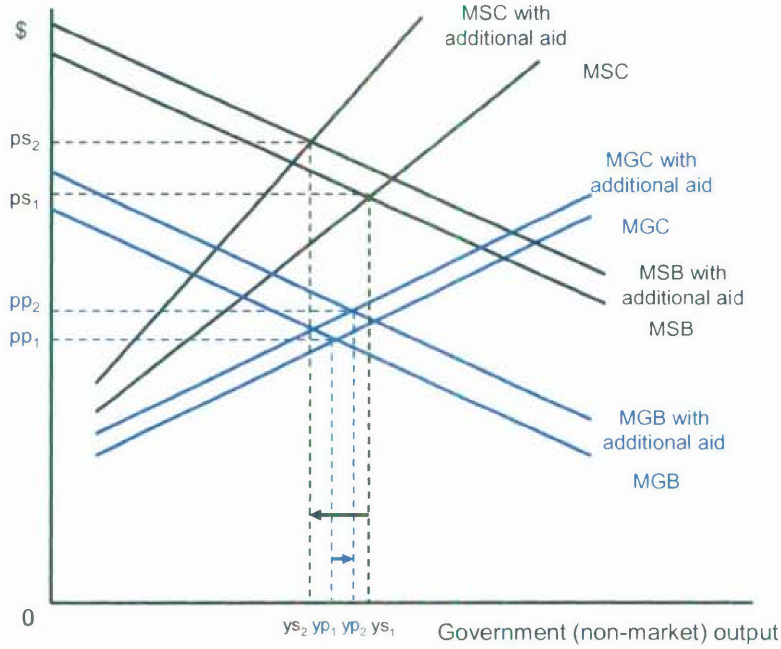
Institutional effects - High levels of aid dependence can reduce the incentive for government to raise its own revenue through taxation, investment and reforms (Harford and Klein, 2005:1-4). Where high levels of TA are provided it can often undermine local capacities, and 'hollow out' institutions. Most recently commentators have compared aid to the 'resource curse' (Harford and Klein, 2005; Djankov, Montalvo and Reynal-Querol, 2005). A further institutional effect is the transfer of skilled domestic human resources away from government and the private sector (Harford and Klein, 2005:3).

Macroeconomic impact - Volatile aid flows can cause short-term currency appreciation, and reduce the competitiveness of domestic exports (White, 1992) and the aid sector can create upwards wage pressures on skilled domestic labour across the economy.

The MIB curve is determined by the quality and efficiency of additional aid. In some cases, well-targeted aid may have a multiplier effect on a country (for example, well targeted support to the education system which builds a cadre of skilled professionals and leaders). Different donors and programs are assumed to have different MIB's depending on the effectiveness of their aid bureaucracy and the quality of their personnel. Only where aid is harmonised (i.e. all donors provide through same channel) could the same MIB be applied to all aid interventions into a country. Easterly's (2002) paper *The Cartel of Good Intentions* provides an excellent description of aid sector internalities that can typically reduce the quality, and therefore potential MIB of aid.

In Figure 4 below, additional government and social benefits are small compared to the additional social costs over the long-run. Individuals, and segments of the population, may directly benefit from additional levels of foreign aid, shown by the increase in output from yp_1 to yp_2. However, the socially optimal level of output has declined from ys_1 to ys_2 because of the large internalities that exist in this fragile state environment which shifts the MSC outwards. The price of government outputs have also increased from ps_1 to ps_2. As a result of high internalities, an increase in aid levels has led to lower government outputs in the long-run.

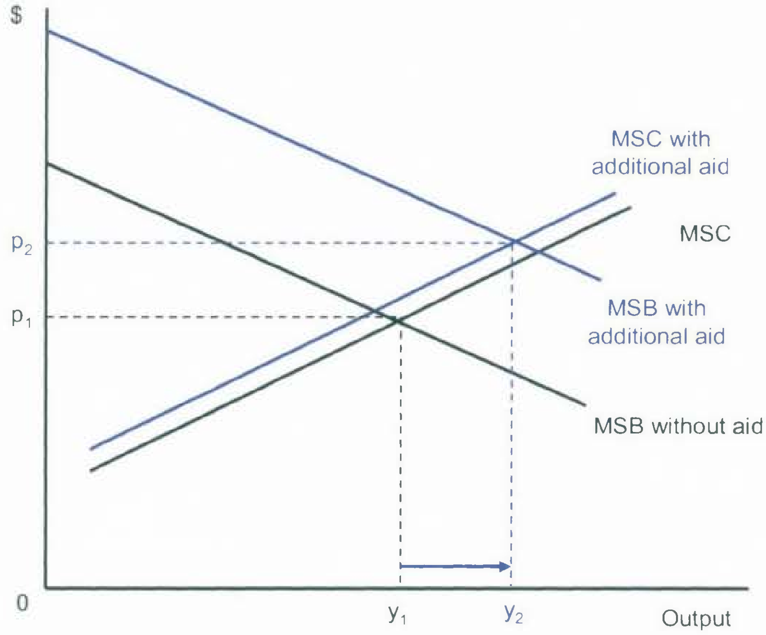
Figure 4: Additional Aid in a Fragile State with High Internalities



Source: Adapted from Fleming (2006:6)

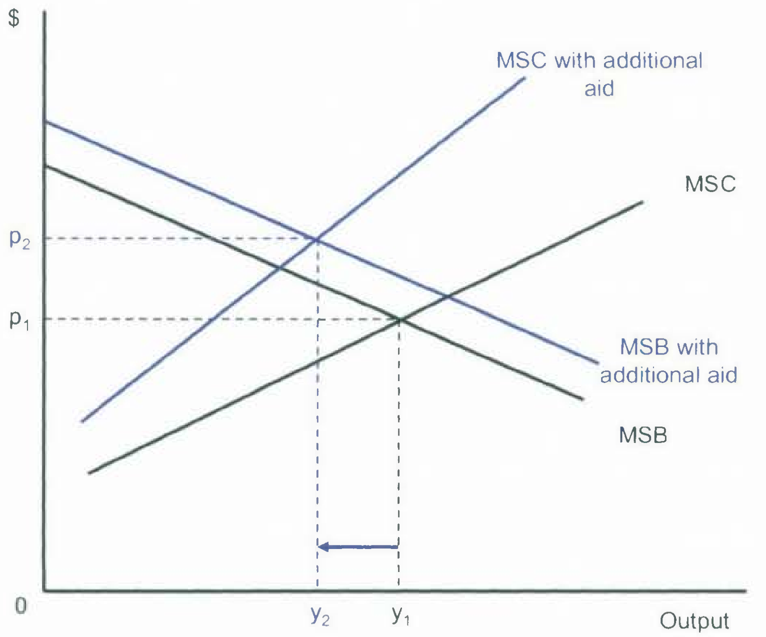
Third, standard MSC-MSB diagrams are used to illustrate the positive and negative internalities of the government sector associated with the provision of aid over the long-run. Two scenarios are presented which illustrate different governance environments. In Figure 5, characterised by good governance, with an increase in aid levels, the socially optimal level of output has increased from y1 to y2. In this scenario, the MIB (positive internalities) from additional aid outweigh the MIC (negative internalities). On the other hand, Figure 6 illustrates a poor governance, or fragile state scenario, where additional aid has been ulitised poorly, MIC is high and thus government output has been reduced from y1 to y2. In Figure 6, the MSB has only shifted upwards slightly as a result of the constraints to the provision of effective aid in fragile state environments. Thus, MIC (negative internalities) outweighs the MIB (positive internalities).

Figure 5: Aid in Good Governance Environment



Source: Adapted from Fleming (2006:9)

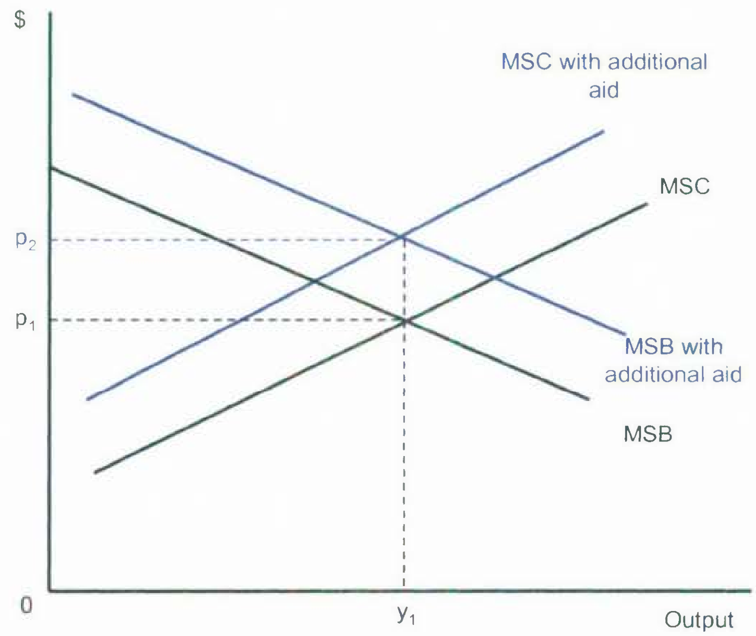
Figure 6: Aid in Fragile State Environment



Source: Adapted from Fleming (2006:9)

It is critical that, at a minimum, aid donors do not seek to supply additional aid beyond the optimum level (i.e. where marginal cost is equal to marginal benefits). In Figure 7 below, additional aid levels have raised the price of supplying aid from P_1 to P_2 but have not changed the output level which remains at y_1. This illustrates the case of 'least worst' interventions (where MSB=MSC) initially discussed in sub-section 3.1.1.

Figure 7: Optimum Aid



However, this analysis is over simplistic because it is set out within a long-run time frame. Assuming aid to fragile states could positively shape the quality of institutions over the very long-run (say 50 years), aid from years one to 20 may lead to a reduction in government output (i.e. Figure 5), however over the very long-run may eventually stimulate an increase in government output (i.e. Figure 6). Both the economic institutions and donor literature suggests that this turnaround will only occur if the negative internalities of government and associated aid flows are reduced. This requires improvements in political markets, the effectiveness of the public sector, and the quality of aid interventions. Donors should seek to find equilibrium by continually evaluating the society-wide impacts of aid interventions over short, medium, long and very long-run timeframes.

4. 3 The Practice of Strengthening Institutions in Fragile States

At this point, there seems to be broad understanding of the theory behind institution building and policies prescriptions to match, however less consensus on best practice in implementation. In this respect, development aid policy is a long way from claiming to know exactly *what* and *how* to support reform in fragile states. Despite large gaps, there are some clues to the approach and direction the donor community should take to optimise aid effectiveness in fragile states. Section 4.3 summarises emerging consensus views on the *what* and *how* of influencing a more positive institutional path.

4.3.1 Remain Engaged with the State

It is broadly acknowledged that improving institutional quality, and the attendant governance attributes of state, is a necessary condition for development (see, Grindle, 2002:28). Few contend that donors should aim to support civil society to transplant the functions of state (Van de Walle, 2005:26-28). The World Bank (1997:30) maintains that even small increases in state capabilities make a "vast difference to growth" and thus aiming for small improvements in a state's minimal governing functions is highly desirable. The fragile state literature outlined in chapter 3 strongly suggests donors should remain engaged with the state, where marginal improvements in institutional practices are possible. However, the literature concludes that reform agendas need to be simplified and better prioritised, if aid interventions are to have any impact whatsoever.

Grindle's (2002) 'good enough governance' agenda assists us in addressing the *what* of aid approaches to fragile states. First, donors could most usefully seek to work with reform agents to improve core aspects of governance where there is an impact on poverty alleviation (for instance, reforms that improve service delivery), rather than governance reforms where there is no impact on poverty. For example, by focusing on improving implementation of health programs rather than the overall health plan which in a weak governance environment is unlikely to have trickle-down effect. Second, to maximise the chances of continuing the appetite for reform over the medium term, it is critical to select reforms that produce broad political benefits. Third, where feasible, it is important to select reforms that are easy to monitor and measure so that reforms can be communicated. Grindle (2002:4) suggests that budgeting and public expenditure management is an area that can be monitored and measured. In some countries, such as Zimbabwe, these desired pre-conditions for working with the state on a reform basis may not exist. In these circumstances, drawing on LAP and LICUS approaches, it is important to remain engaged and work with an array of state and non-states actors where some of these pre-conditions exist.

In essence, Grindle and others (see, for instance, LICUS Taskforce, 2002; World Bank, 2005b) have proposed that working towards a small, but strategic, number of reforms (which the World Bank has recently termed 'strategic incrementalism') has the greatest prospect of having an impact. It is acknowledged this process will be a "slow, reversible, and frustrating path towards better performance" (Grindle, 2002:2), and that there are no technical blueprints for success. Rodrik et al (2004) for instance argued, based on econometric studies, that there is no evidence of one set of institutional circumstances and policies that can craft economic growth and development. Drawing on the 'Drivers of Change' approach, by agreeing to support particular aid interventions over others, donors need to understand the positive and negative effects on the country, and the incentives and disincentives aid interventions have on local reform processes as a result of these interventions. In fragile states, as illustrated in Section 4.2, it will often be a case of selecting the interventions that minimise negative incentives, and choosing the 'least worst' interventions.

Assuming donors adopt 'strategic incrementalism' as a policy platform for aid, *how* they actually deliver their programs is just as important as the identification of the policy. In short, the more aid can be delivered through indigenous systems on the basis of mutual obligations between a local organisation and the donor, the more likely it will succeed. If an aid package adopts a *functional-push* strategy where there is no performance expectation, and does not build on indigenous momentum for change, then it is unlikely that positive change will be sustained beyond the period of the program. It is acknowledged that in the context of fragile states, it will be difficult to work through all aspects of government systems and donors need to go down to the local levels and partner with as many institutions (i.e government, non-government, private sector) that can deliver services, and act indirectly as long-term agents for reform. Drawing on the LICUS and LAP recommendations in section 3.2, in a fragile state context there is a need for donor agencies to much better coordinate aid interventions at the strategic and program level to reduce the negative effects. Most critically, it is essential that donors programs are not working against each other in terms of the flow-on incentives upon local actors to improve their own capacities and systems.

4.3.2 Concentrate on inducing Political and Social Change

Both the institutional economics literature and more recent development policy papers have brought the importance of political institutions to the forefront of our consideration of better governance and stronger economic growth. Grindle (2001) contends that development practitioners should cease looking at politics as a constraint to development and appreciate it as part of the broader development conundrum. In post-colonial states undergoing transition from a traditional to modern society, political institutions are usually a hybrid of formal and informal institutions. Furthermore, most citizens define their relations with the state in terms of the local community, local values and customs. As a result, politics is overwhelmingly local and clientalist (Barkan et al, 2004:220-224) and formal institutions naturally becomes the arena for traditional political competition

(Ketan, 2004:19). In this respect, the principal-agent relationships, implicit within modern democratic states, take on a different shape to Western democracies. This is due to divisions in society that relate to traditional conceptions of principal and agent relations, rather than the notion of the benevolent state.

Vallings and Moreno-Torres (2005), drawing on a study by Goldstone et al (2004) have argued that dysfunctional political institutions are the central driver of state fragility, and as a result, donors should have a significant long-term focus on altering the political market. Hegre, Jones and Strand (2003) provide further evidence that political consistency (regardless of regime type) is the most significant indicator of fragility. Hegre et al (2003) contend that the institutional enforcement mechanisms, which limit executive power and shape political competition, are the core aspects of the political system that usually need to be strengthened. In transitional countries this means laying the foundations of political institutions by bridging informal cultures and traditions, and the formal rules of the state. However, according to Williamson's (2000) analysis of the time horizons for institutional change outlined in sub-section 2.2.3, altering culture and traditions is the slowest type of institution to change. Political institutional development is also extremely difficult for external agents to affect when the majority of political actors have entrenched interests in exploiting the weaknesses in the existing regime to maintain power and control of the state's resources.

Despite these challenges, Barkam et al (2004) have argued there has been some evidence in Africa of incremental improvements in the strength of political institutions. This has occurred through gradual process of better educated Members of Parliament (MPs), by small improvements in the public administration of Parliament and encouraging more local debate on key development issues. Consistent with the economics institutions literature this change is overwhelming slow and can easily reversed.

Like all institutional reform processes, improving the quality of political institutions in democracies relies on strengthening the contract between agent and principal; that is, political accountability. However, where the majority of people in a country are poor, and subject to geographic, ethnic and communication divisions, they have limited common grounds and means to "mobilise political power, use it to express needs, demand response and holding officials responsible for a response" (Grindle, 2002:24). Although acknowledging the process of political change is difficult, Grindle (2002:24-25) contends there are ways aid can, usually indirectly, help develop the poor's access to information and capability to organise themselves through political parties, labour organisations and the media, to facilitate greater accountability and reduce political market failure. At the least overtly political end, increasing the flow of information about the role of government, budget information, and citizen's rights, to provide people with the context to demand greater political accountability is helpful (Grindle, 2002:44; World Bank, 2005b:326; Kaufmann and Kraay, 2003:3)

In a fragile state context, where civil society organisations (CSOs) are typically small, factionalised and weak, tax collection is limited, and the private sector is underdeveloped, the development community is only just beginning to experiment with assisting civil society to demand greater accountability from the state. This means helping to build institutions from the bottom-up (i.e. community notions of governance), and at the national level (i.e. national think tanks and public information campaigns) by supporting a wide range of civil society groups to build their capacity over a long period of time. According to Van Rooy (1998:199), donor funding to CSOs can only be "relevant as small, strategic interventions in a bigger picture of social change" and cannot in itself be expected to be the agency of change. This finding is complemented by the voluntary sector failure theory (see Dollery and Wallis, 2001:10-15; Wolf, 1993:90-93) which explains why CSOs are also subject to institutional failures, analogous to theories of government failure.

4.3.3 Incentives

Even if an aid donor follows the approach described in sub-sections 4.3.1 and 4.3.2, donors can still prevent organic reform if they misread the incentives of their aid. Thus, understanding that aid is part of the incentive structure in recipient countries, that will alter the institutional environment in all recipient countries is an important first step in the process of correcting them.

'Getting the incentives right' is probably the most challenging part of delivering aid in a fragile state environment. For instance, funding service delivery in a poor governance environment is by definition highly fungible, and will have both positive and negative effects on a country. On the one hand, providing services that are not being provided by the state through aid financed organisations, acts as a clear negative incentive for reform in the recipient state because it takes on the core responsibility of the recipient state. In effect, aid can reduce the pressure on the state to fulfill its core minimalist functions, and frees up more resources for political patronage. On the other hand, if core services are not being provided the social situation is likely to continue to get worse, and could escalate into major civil conflicts. Drawing on section 4.2, the optimal aid intervention should aim to support critical service delivery so that the benefits outweigh the costs, or harm, of aid.

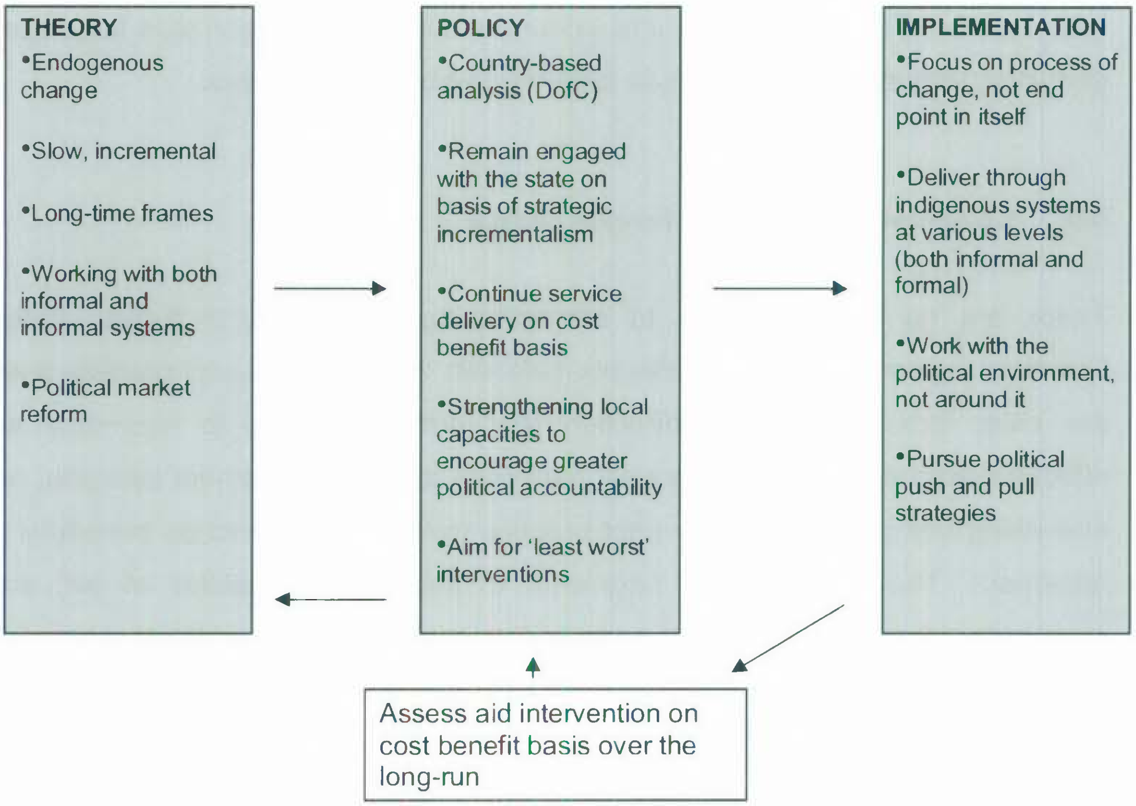
Optimising the impact of aid is easier said than done. In practice, the political-pull and push strategies outlined in section 3.1, Table 2, provide an informative framework for designing more aid interventions using an incentive-based approach at the operational level. At the macro level, aid frameworks that deliver on-budget aid on the basis of demonstrated performance, such as the US MCA, and some sectorwide approaches, go furthest in moving towards a genuine incentive-based approach. Nevertheless, these approaches are only as good as the performance framework and monitoring tools which assess the ongoing capacities and actual resource allocation decisions of local institutions. At the global level, there are numerous regressional analyses that find a negative correlation between aid dependence and the quality of institutions (see Knack, 2000). However, there are few studies that seek to analyse the impact of aid programs at the input to output level within a country, or sector, using an institutional framework to assess negative and positive incentives.

As a start, if donors are to take aid optimisation seriously, regular evaluations need to be undertaken at the country, sector, program and TA level. Independent evaluators would be tasked with assessing the positive and negative effects of interventions. To do this properly it would need to be assessed over at least 20 years, and look at both hard outputs (i.e. budget outcomes, staff attendee rates) and soft outputs (i.e. changes in attitudes). Generally, because the bulk of global aid is focused on the state, evaluations would look at changes in the performance of state institutions, and local individuals within these institutions. To begin to fill this gap chapter 6 and 7 will assess Australia's aid interventions in Papua New Guinea.

4.3.4 A Framework for Aid Interventions in Fragile States

To conclude section 4.3 this sub-section seeks to draw the theory, policy practical aspects of aid delivery together into a common framework. Based on the key findings in chapter 4, Figure 8 below is an attempt to summaries the main conclusions on best practice to institutional change in fragile states. The framework seeks to link together the key findings from the institutional economics explored in chapter 2 and section 4.2, aid policy discussed in chapter 3 and sub-section 4.1.1, and best practice in implementation considered in sub-section 4.1.2 and section 4.3.

Figure 8: A Framework for Aid in Fragile States



This framework is not intended to be prescriptive, nor offer a blueprint for aid in fragile states. Instead it offers a tool for assessing the linkages between evolving theory, policies and lessons of implementation in fragile states, whereby the clockwise direction arrows are intended to indicate that evaluation should feedback to influence policy and theory. It is proposed that this framework illustrates the new 'augmented Washington consensus'.

By advocating an approach that seeks to pursue the 'least worst' interventions, this framework accepts the geopolitical realities of foreign aid, as well as the inherent negative effects of delivering within a poor governance environment. It adopts an approach which sits closer to the soft end of the continuum within fragile state paradigm because even in the instance of large scale state-building exercises these core theoretical, policy and implementation issues need to be considered in its design. Furthermore, it could be argued that assessment of marginal costs and benefits is more essential in large scale state-building interventions. To date, there is little evidence that these assessments have been genuinely undertaken by donors in major state-building exercises.

4.4 Conclusions on Aid to Fragile States

There are no easy answers to strengthening institutions in fragile states. However, by concentrating on the link between theory, policy and practice there are clear indicators of the direction that donors striving to maximise aid effectiveness need to take. Like past panaceas to the development dilemma, not everything being prescribed as best practice today will prove to be beneficial in retrospect. This framework is cognisant of the political realities of aid, and accepts that there will always be a gap between good theory and best practice. In this sense minimising the negative impacts of aid and aiming for the 'least worst' interventions is a desirable policy outcome given the inevitable non-market failures associated with foreign aid.