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State Fragility and International Development Cooperation

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Abstract

Over the past few years addressing state fragility in the third world has become an important priority in international development cooperation. However, it seems that the international donor community has so far not been able to develop adequate instruments for dealing with the problems posed by state failure. We see two reasons for this: (i) there is growing recognition within the donor community that the lack of absorptive capacity, or bad economic policies in the partner country can actually make aid counterproductive, even harmful; and (ii) it is very difficult to manage effective development cooperation with weak governments. Channelling aid through NGOs, or giving limited aid in the form of capacity-building is clearly not sufficient to solve the problems fragile states face.

In order to minimize distortions caused by aid, the literature advocates a policy-based selective approach, i.e., limiting aid funds to recipients with 'good policies'. However, failed states (and many weak states for that matter) do not have the capability to formulate good economic policies, and some countries face serious challenges in

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Keywords: development cooperation, aid, failed states, state failure, absorptive capacity, Dutch disease, selectivity, good policies, Millennium Challenge Account

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meeting the criteria of good policies posed by the World Bank/IDA or the US in its Millennium Challenge Account. An important reason for this is that reforms within recipient countries aimed at forming good policies (especially liberalizing international trade, curbing inflation and cutting the budget deficit) create winners and losers, and the losers in fragile states can be strong enough to block policy changes or even cause conflict.

We conclude that in order to better help weak states, the criteria for good policies must also include criteria for forming policies that compensate losers. Donors must help recipients in formulating such policies. To further ensure that losers of policy reforms do not block change, donors must pay greater attention to conflict prevention and social mediation in weak states, and to conflict management and peacebuilding in the case of failed states.

Acronyms

CPIA	country policy and institutional assessment
IDA	International Development Association
MCA	Millennium Challenge Account
MDGs	Millennium Development Goals
NGDOs	nongovernmental development organizations
NGOs	nongovernmental organizations
NSS	National Security Strategy (of the United States)

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1 Introduction

Interest in international development cooperation and foreign aid has greatly increased since the millennium. This increased attention also brings with it a shift in emphasis: dealing with the questions and challenges posed by state failure in the third world with the help of foreign aid has gotten a much greater role than ever before. Practically all poor countries (and especially least developed countries) can be considered as weak or potentially failing states if we accept the security-oriented definition of state failure (Rotberg 2002, 2003). These countries are not capable of providing essential public services such as healthcare, education, clean drinking water or sanitation, but in many cases even face severe problems in guaranteeing basic public goods such as public order, security or a clean environment, most of which can be considered prerequisites for development. Without a stable government to provide essential services and public goods, the quality of life and prospects for the future of the inhabitants are greatly decreased.

The existence of such states, however, has even wider implications, as they also pose a threat to their neighbours and the international community. States that are not capable of controlling their territories may unwillingly give haven to terrorist and organized crime groups. Without healthcare, the population's resistance to epidemics can severely be reduced. Poverty and lack of state services are a strong pushing force for migration. State fragility and weakness may tempt various fractions to try and capture the state, thus leading to civil war which can potentially escalate to regional levels, as shown by the experiences of Rwanda and the Congo (former Zaire) in the mid-1990s, and become a cause of humanitarian disaster. Such consequences of state failure pose a direct security threat to the developed world as well: terrorism, drug trafficking, illegal migration, epidemics (such as SARS or avian influenza), and the effects of violent regional conflicts all have direct implications also for rich nations.[1] It is, therefore, of vital interest for developed countries to address the root causes of these global challenges, namely, widespread poverty and state failure. In theory, international development aid should be a perfect tool for this task.

This paper will review the ways in which the international donor community tries to address the issue of state failure in developing countries and examine how effective current aid practices are dealing with the issue. The increasing policy-based selectivity in aid allocation does not favour weak states, and the paper will argue that the selectivity paradigm must be reviewed in order to develop an international aid regime that can truly combat state failure.

Some terminological clarifications are in order. The term *weak states* refers to countries in which the government is not capable of providing public services (healthcare, education, water and sanitation, etc.), but has a monopoly of violence within its geographic boundaries. *Fragile states* is used synonymously with *weak states*. The government of a *failed state* does not have a monopoly of violence, that is, it is threatened by regional uprisings, outright civil war or other insurgent activities. We refer to countries with no central government as *collapsed states*.

1 For a detailed analysis on security threats posed by failed states, see Rotberg (2002).

In the first section of the paper we examine a few relevant features of the international development cooperation regime. The second section deals with the negative economic, political and sociopolitical effects of aid, which can make developing states even weaker, in sharp contrast with the declared goals of aid. International policy responses to such distortions, namely the rise of policy-based selective aid allocation and the meaning of good policies, as well as a possible expansion of the meaning are discussed in the third section. The fourth section analyses the most widely used methods for cooperating with failed states.

2 The international development cooperation regime

During the cold war, development cooperation was strongly subordinated to the interests of the two superpowers. Both blocks used development funds to reward or punish third world countries and former colonies according to their strategic interests (Alesina and Dollar 2000). Poverty reduction and promoting economic growth came second only after the donors' political interests; and the problems of state failure were largely obscured by the rivalry of the two sides. It is hardly surprising, therefore, that after the end of the cold war (and the rise of neoliberalism) aid flows declined in both absolute and real terms, as did the popularity of development cooperation. However, at the turn of the century, the Millennium Development Goals (MDGs) ratified by the UN General Assembly in 2000, as well as the terrorist attacks in the US in September 2001 played an important role in focusing the world's attention to the problems faced by developing countries. Since then there has been a resurgence in aid flows, and the scholarly debate on the subject has intensified as well.

However, aid is still highly political, and greatly influenced by donor interests and background motivations. The majority of development resources are not given to the countries most in need. Strategic interests, as well as a desire for political and economic benefits are important factors in aid allocation, as early studies, such as Maizels and Nissanke (1984), and Cassen et al. (1986), show. It seems, however, that the end of the cold war and the interplay between state failure and globalization have caused a shift in donor interests, bringing them closer to those of the recipients. Terrorism, organized crime, global epidemics, and uncontrolled mass migration are the main security threats of the early twenty-first century. Military power and increased homeland security are insufficient for dealing with these threats, as they do not address their underlying cause, namely global poverty. This is where soft power in the form of aid comes in the picture. The war against poverty is also a war against state failure, as development increases government revenues and therefore enables the state to increase spending on such crucial tasks as the immunization of the populace, helping those most in need or prevention of internal conflict. Therefore, establishing the institutional, human capital and infrastructural prerequisites for poverty reduction and sustainable economic development, as well as fostering good government practices, transparency and putting an end to corruption are in the interests of both donors and recipient countries. It is logical, therefore, to expect in the allocation of donor funds a shift in favour of least developed countries and weak states.

3 Bad incentives and distortions caused by aid

The experience with development aid is, at best, mixed; in fact, many scholars (most notably Peter Bauer 1991 and Deepak Lal 1985) have questioned the rationale for aid. In certain instances, aid actually weakens the recipient economy and its institutions, and so can be defined as a potential cause of state failure. There are, of course, cases where aid seems to have worked, but more often it merely contributes to sustained weakness and vulnerability of the recipient country. The distortions caused by aid are widely discussed in the literature, and only a few of the more interesting issues are examined here.

If a partner country does not have *ex ante* a stable institutional structure, or its government pursues detrimental economic policies, aid can lead to disastrous consequences.[2] Without sufficient absorptive capacity, aid can cause more harm than good, as their growth-generating effects are negated by various distortions that may even cause the recipient serious crises (Rajan and Subramanian 2005a: 22). Perhaps the most well-known among these distortions is the so-called 'Dutch disease', which has recently received much attention in the literature (Gupta, Powell and Yang 2005; Rajan and Subramanian 2005a; 2005b). Dutch disease type effects ultimately lead to a loss of international competitiveness and a contraction of the export sector, although the mechanism can greatly vary depending on the exchange rate regime used by the recipient country. In case of fixed exchange rates, aid inflows, unless they are all spent on imports, constitute surplus demand in the goods market. This does not necessarily imply a problem if the economy is running at full potential (i.e., it is constrained by demand in the Keynesian sense). Government projects and programmes funded from aid usually require skilled labour (doctors, teachers, nurses, engineers, etc.), which is in short supply in developing countries. Consequently, aid projects can increase the demand for a resource in short supply, leading to an increase in the price of that resource (in our example, the wages of skilled labour). The government can use part of the aid money to pay the higher price, but as the private sector does not receive compensation for the increase in input costs, it will be forced to increase the prices of the goods it produces. The export sector, on the other hand, will not be able to raise prices because it faces the pressures of international competition, and so will have to absorb the loss in competitiveness. Export-producing firms may lose markets, and will be forced to cut production which, in turn, will lead to growing unemployment.

In case of floating exchange rates, the rate is appreciated when the central bank exchanges the aid funds to domestic currency. The stronger currency has the same effect as rising wages, since the earnings of the export sector will be less when exchanged to domestic currency. In both cases the result is the same: contraction of the export sector, rising unemployment and diminishing government revenues. Rajan and Subramanian (2005a) show that Dutch disease type effects are not just theoretical speculations, but are clearly present in heavily aid-dependent economies. Certainly, the effects could be

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2 Provided that the inflow of aid is sufficiently large compared to the size of the economy. It is not easy to determine what level of aid would invoke these distortions; a vague rule-of-thumb usually points to 10 per cent of national income. In many Sub-Saharan countries, aid inflows are far above this percentage (Akram 2003: 1352), so they are particularly vulnerable.

mitigated with appropriate policy measures,[3] but that would assume an efficiently working institutional setting and a government committed to development with highly trained, competent policymakers. These are frequently lacking in weak developing countries.

Another frequently cited distortion caused by the inflow of aid is aid dependence, but the literature is not exactly consistent on what this actually means. To put it simply, aid dependency can be measured as the percentage of aid in government revenue, or in national income. The government can easily become accustomed to aid inflows, and develop a strong interest in increasing these inflows, or at least sustaining them at current levels. Reforms that would ignite economic growth will not figure high on the agenda, because growth would mean rising government income and a diminishing need for aid. Since performance requirements are rarely enforced by donors, recipients can get away an inefficient utilization of resources and without showing any substantial results (Easterly 2001). The percentage of aid in government expenditure in some Sub-Saharan African countries can reach 25-40 per cent, but can even account for 90-100 per cent of gross capital formation (Akram 2003: 1353). Drastically cutting aid flows to such heavily dependent economies cannot be a credible donor threat, as it would definitely lead to crises and work against donor interests in the long run. Aid dependency and the possibilities for corruption associated with aid can be symptoms of a weak institutional structure, but they also create strong counterincentives for formulating policies that would ultimately lead to the strengthening of the state.

Aid can cause many other distortions, and these have been relatively neglected in the literature. In a recent paper, Moos, Pettersson and van de Walle (2006) review the negative impacts of aid, concentrating their effects mainly on the recipients' institutions. They argue that large aid flows can seriously undermine a country's institutions, by weakening especially government incentives to collect tax revenues. Aid, being an unearned form of revenue, not only creates incentives against policy reforms as mentioned above, but can also be a substitute for other forms of government income. Collecting tax puts a certain amount of pressure on the government to be transparent and accountable to taxpayers, but if elites are not dependent on tax money, there is no need to be accountable, or at least not towards the taxpayers. Thus, governments will prefer aid over taxes, as then they will need to be accountable only to donors, not to the general public of the country. Building an effective tax administration will not be priority, and so the need for aid will not decrease. Moos, Pettersson and van de Walle (2006) show quite convincingly that high taxes *and* high inflows of aid do not co-exist in any developing country, although they stress that the quality of their data is questionable. The capacity to collect taxes is indicative of how strong the state institutions are, so once again aid can be perceived as a source of state weakness.

One conclusion is apparent from this short, and of course by far incomplete, review of distortions caused by aid. While an important goal of aid should be to help the recipient develop a working institutional structure that promotes economic growth, in some cases it actually works against this goal and contributes to sustained weakness. If full benefits of aid are to be reaped from, such an institutional structure has to be already in place.

3 Such as currency market sterilization by the central bank, or spending a larger share of aid on imports (Gupta, Powell and Yang 2005). However, in the long run, policies aimed at removing resource constraints in the economy are probably the most efficient tool.

The lack of good economic policies and institutions in weak states makes certain that the negative effects of aid remain dominant.

3.1 The changing relationship between donors and recipients

Establishing a link between the quality of the partner country's institutions, policies and the levels of development aid it receives was first advocated by the World Bank in its 1998 report titled *Assessing Aid*. Since the report was published, many authors have tried to prove that aid to countries with good policies does have a positive impact on growth (Burnside and Dollar 2000; Collier and Dollar 2002 being the most influential ones). According to Collier and Dollar's (2002: 1495) allocation model, the only way to ensure the maximum efficiency of aid resources is aid is concentrated on countries where the level of poverty (the percentage of those having an income/consumption under the absolute poverty threshold of two dollars a day) is high, and the government is committed to good policies (measured by the World Bank's country policy and institutional assessment, CPIA). Marginal productivity of aid is highest in countries with high poverty headcounts, and good policies ensure that they are absorbed without generating distortions. According to this selective approach, countries with bad policies should not be allocated aid, or at least their share should be greatly reduced. According to the underlying hypothesis, countries with bad policies, seeing that their counterparts with good policies receive more generous aid allocations, will be forced to adopt good policies themselves. Good policy practices would subsequently spread to each developing country in a similar spillover fashion.

3.2 The selective approach to aid and weak states

If one blindly follows the policy-based selective approach, it can be easily concluded that aid to weak and failed states should be reduced, or even suspended totally in some cases. This conclusion, however, is the reverse of what common sense would indicate. All forms of internal instability[4] represent serious danger to the recipient country, increasing the vulnerability of the economy to external shocks, and compounding the suffering and hardship of the population. Therefore, such a country is in need of more foreign aid, not less. In theory, donor reaction to instability can reflect many factors (Chauvet 2002: 39). If the donor has high stakes in the partner country (such as a high outward foreign direct investment stock), it may be interested in protecting these, and will thus increase its volume of aid. But it is much more difficult to cooperate with failed states, as their governments may have more pressing tasks such as trying to cope with interior conflicts (insurgent and guerrilla activity, assassinations, kidnapping, strikes etc.) than cooperating with donors or formulating efficient policies. In these difficult situations, it is extremely challenging to ensure efficient use of development resources, or even monitor their utilization by the recipient. The lack of public order and security makes it difficult for donors and the recipient government to implement development and growth stimulating policies, not to mention combat corruption. In short, donors face an important dilemma with regard to failed states: the recipient—due

4 Gupta (1991) distinguishes three sources of instability within a state: (i) violence against the state (uprisings, demonstrations, civil war, assassinations, etc.); (ii) violence within the state (such as a *coup d'état*); and (iii) violence by the state (executions, genocide, and any other serious violation of human rights).

to the severe nature of state fragility and instability—would need more resources, but the efficient usage of these funds cannot be guaranteed. Giving aid to failed or extremely fragile states is not justified with the policy-based selective allocation approach.

The selective approach also has some important ethical implications that economists tend to overlook. Can a donor expect the inhabitants of a recipient country to fend for themselves if their government does not have the capacity, or simply does not want to implement good policies? The effect on the population would be twofold: they would be handicapped by their government's bad policies and weaknesses (such as low level healthcare and education, etc.), as well as by the lack of foreign aid. Inhabitants should not be punished or held responsible for the actions of their government, especially if it lacks a democratic mandate. The people cannot be deserted if official aid to a recipient country is suspended, and the provision of relief must be arranged through different channels, such as nongovernmental organizations. This is discussed later.

The spillover of good policy practices mentioned earlier seems to be nothing more than theoretical speculation; to date, there is no proof to substantiate the theory. Though many authors (see, for example, Hansen and Tarp 2001; Easterly, Levine and Roodman 2003) dispute the Burnside-Dollar (2000) evidence on the link between the quality of policies and the impact of aid, the policy-based selectivity has had a huge impact on the allocation of funds by International Development Association (IDA) funds, as well as by many other donors. A recent study shows that selectivity is increasingly present in the aid allocation decisions of donors (Dollar and Levine 2004). Pressure from voters might also push donor governments to prefer partner countries in which at least a minimum level of transparency and accountability is guaranteed, as voters can be quite sensitive to accounts of corruption in connection with aid that is financed with their tax money.[5]

3.3 What are good policies anyway?

An important question is what do we mean by *good policies*. Transparent government practices and accountability, as well as fighting corruption are certainly part of the package, so is providing an incentive atmosphere for domestic business (institutions that guarantee property rights and the enforcement of contracts, low administrative and tax burdens, etc.) but what else? Easterly (2001: 118) also includes low inflation, interest rates determined by the free market, low budget deficits, all of which are plausible and can be added to our list, although a low budget deficit and low inflation should only be interpreted over a longer period of time. What else is needed for aid to have a positive effect on growth? Is trade, or capital account liberalization necessary, for example? Should state controlled enterprises be privatized? What kind of exchange rate regime is needed? These are questions on which development economists have so far failed to find convincing answers, and the experience is contradictory as well. Many economies have managed to achieve spectacular growth rates with seriously restrictive trade or

5 Development cooperation in general is well supported by the public in donor countries. According to a 2003 Eurobarometer survey, 86 per cent of the population in the EU-15 agree or strongly agree with the statement that cooperation with the third world is important (The European Opinion Research Group 2003: 1). Still, public opinion is very sensitive to news of wasteful usage of aid and related corruption.

foreign investment regimes. Japan, for example, is still a relatively closed economy in terms of inward foreign direct investment stock. On the other hand, countries in Latin America have suffered dire consequences for trying to establish autarky during the 1970s. Supporters of globalization argue that liberalizing trade is good for development (Dollar and Kraay 2001). Yet, export supply in developing countries is typically inelastic (World Bank 2005a: 118), in other words, these economies are not immediately ready to reap the benefits of freer trade, but they will definitely suffer from increased competition from cheaper imports. Furthermore, many developing countries are commodity exporters. As Birdsall and Hamoudi (2002) show, in the past decades relatively open commodity exporters have actually experienced slower growth than other developing countries. A widely cited argument for trade liberalization is that growing international trade would lead to wider supply of goods, thus decreasing prices and lowering inflation, bonuses for the poor. Prices, however, tend to be sticky and seldom decrease. Capital account liberalization can be beneficial if managed well, especially if the country wants to attract foreign direct investment, but deregulating short-term capital transactions can have severe consequences in economies that lack strong financial market institutions, as shown by the East Asian financial crises in 1997.

According to Kosack (2003), aid in democratic countries is much more effective in reducing poverty because democratic governments, faced with regular elections, have a strong incentive to use aid resources to improve living standards. This conclusion could lead to an even more restrictive theory of selective aid allocation—only democratic or democratizing countries should receive aid. History, however, is not consistent with this conclusion either. There is ample anecdotal evidence of rapidly growing authoritarian countries, such Chile under Augusto Pinochet, or South Korea under Park Chung-hee.

The most important question, therefore, is how donors interpret ‘good policies’. What are the criteria they consider? Perhaps the most clear cut example of foreign aid influenced by policy-based selectivity in the United States’ Millennium Challenge Account (MCA). Announced by President George W. Bush in March 2002, this new development fund aims to increase US development efforts by five billion dollars annually, but to a limited group of partner countries only.[6] According to the original plan, grants from the MCA would be allocated to a small group of least developed countries committed to good policies, and the recipients themselves would gain a larger role in planning projects and programmes funded by aid, but would need to be highly accountable (Radelet 2003: 109).

It is not easy to get funds from the MCA. The Millennium Challenge Corporation, the aid agency charged with administering the MCA, monitors the potential recipient countries with 16 quantitative indicators in three categories (see Table 1). The various indicators are measured and published annually by international organizations, such as the World Bank, the IMF, or NGOs like Transparency International or the Heritage Foundation. In order to receive MCA funds, a country must have ratings in at least half

6 The goals and underlying philosophy of the MCA are closely related to the US’s National Security Strategy (NSS). Published by the president in September 2002, the NSS names failed states as the most severe threat to the US, mainly due to the security risks mentioned earlier. The NSS emphasizes the role of development aid in combating state failure, and the MCA is meant to be the instrument for this goal. For more information on the MCA, see Brainad et al. (2003) or Radelet (2003).

of the sixteen indicators that exceed the median of all countries, and must score above the median in corruption.[7]

Policy-based selectivity is also clearly evident in IDA's allocation of aid. Countries with high scores in the CPIA receive higher volumes of aid from the IDA (Dollar and Levine 2004). Criteria for the CPIA are presented in Table 2.

Failed states, and in some cases also weak states, can face serious challenges in formulating policies that meet the criteria. Reforms such as curbing inflation, reducing the budget deficit or liberalizing international trade, included in both the MCA and the CPIA, can create winners and losers. It can be extremely problematic for a country with a weak government to carry out such reforms with only limited external help: decreasing the budget deficit and curbing inflation, for example, require measures such as restricting free access to public services or freezing the pay of public administration officials. This, in the short run, can reduce support for the government, and lead to civil

Table 1
Allocation criteria for the MCA

I. Ruling justly	
1.	Control of corruption
2.	Rule of law
3.	Voice and accountability
4.	Government effectiveness
5.	Civil liberties
6.	Political rights
II. Investing in people	
7.	Immunization rate: DPT and measles
8.	Primary education completion
9.	Public primary education spending/GDP
10.	Public expenditure on health/GDP
III. Economic freedom	
11.	Country credit rating
12.	Inflation
13.	Regulatory quality
14.	Budget deficit /GDP
15.	Trade policy
16.	Days to start a business

Source: Soederberg (2004: 295).

7 So far, the MCC has quite a mixed track record. The agency started operation only in the first half of 2004, and has been painfully slow in screening partner countries. In December 2005 out of about 70 countries classified as least developed countries (LDCs), only 23 LDCs had fulfilled the minimum criteria for receiving funds from the MCA. Twelve countries have handed in project tenders, and the MCC has approved half: Madagascar, Honduras, Cape Verdes, Nicaragua, Georgia and Armenia. The last two countries in list raises further doubts: does the MCA really represent a paradigm shift in the development policy of the United States, or will it become just another instrument in US foreign policy to be used for rewarding countries for strategic and political reasons (Source: www.mcc.org, accessed on 30 December 2005).

Table 2
CPIA criteria

A. Economic management	
1.	Macroeconomic management
2.	Fiscal policy
3.	Debt policy
B. Structural policies	
4.	Trade
5.	Financial sector
6.	Business regulatory environment
C. Policies for social inclusion/equity	
7.	Gender equality
8.	Equity of public resource use
9.	Building human resources
10.	Social protection and labour
11.	Policies and institutions for environmental sustainability
D. Public sector management and institutions	
12.	Property rights and rule-based governance
13.	Quality of budgetary and financial management
14.	Efficiency of revenue mobilization
15.	Quality of public administration
16.	Transparency, accountability, and corruption in the public sector

Source: World Bank (2004).

unrest and increasing levels of corruption. Liberalizing trade can hurt local producers. Widening civil liberties and democratic rights, as emphasized by the MCA, gives the people greater voice and better opportunities to get rid of reforming governments, which can lead to the end of the reform progress. In short, reforms change the distribution of resources, some groups win, some groups lose. Losers from the reforms will have strong incentives to block them with whatever means they have. Governments can thus face strong domestic pressures against reforms. The weaker the central government and the state administration, the more likely it will give in to such pressure.

It is argued, therefore, that in order to formulate effective selectivity criteria, the definition of good policies must be reconsidered. 'Good policies' must also include criteria for policies and institutions that compensate the losers of reform policies aimed at growth, with such options as building social safety nets, concessional finance to help local companies adjust, improved access to micro credit or subsidies to sections of the population most in need. If the losers are compensated, they will be less likely to block reforms. Of course, compensation reforms require funding, and if financed from the government budget, these can have opposite effects to what the original aid reforms aid intended by formulating good policies. Donors should designate aid commitments in advance, conditional on whether reforms are implemented, and recipients could borrow against these commitments. If reforms are delayed beyond a given deadline, the donor could revoke the commitment, and the recipient would have to repay the funds. This could induce a sufficiently strong incentive for recipients to form good policies, including policies that compensate losers.

3.4 Possibilities for cooperation with weak states

Failed and weak states incapable of implementing good policies cannot ignored, and the international donor community must help them in all possible ways, while simultaneously working to avoid the bad incentives and distortions associated with aid in the case of these recipients.

The literature usually cites two possibilities for helping failed states without committing substantial aid flows (Degnbol-Martinussen and Engberg-Pedersen 2003: 267): aid could be either (i) channelled through nongovernmental development organizations (NGDOs), or (ii) concentrated on government capacity-building. NGDOs work directly in the field, thus they are able to reach the most needy of the poor and empower these people by implementing development projects jointly with them. These organizations are quite flexible, and by by-passing local government they can work in countries where the administration has collapsed, or is off-limits for western donors.[8] NGDOs usually operate with lower overhead costs than official development agencies, but their size and lack of contacts with the administration make it difficult for them to undertake larger projects. Perhaps the most disputed feature of the NGDOs is that they do not contribute to the institutional capacity-building of the state. The fact that they by-pass the government, and in many cases provide the public with services that should be the responsibility of the government means that they can have adverse effects on the institutional development of a recipient country and do not contribute to strengthening the state. NGDOs can, nevertheless, play an important role in reducing the local population's suffering and in providing basic health services and education, although the lack of public order in failed states poses a challenge to their everyday operations. On the other hand, though, best results are clearly achieved when the NGDOs complement official donors, not substitute them.

The goal of capacity-building is to help failed or weak states gain strength (mainly from an institutional point of view) and become capable of assuming their responsibilities. Development cooperation aimed at capacity-building suggests a much lower level of funds, and usually takes the form of technical cooperation, such as training state bureaucracy or consultancy services on developing new policies, legal instruments or government agencies. Advisory support on formulating good policies can therefore also be interpreted as a form of capacity-building. Capacity-building, in theory, can help a country to develop to the level that it is able to fulfil donor criteria with respect to policy. But many questions arise. How long does it take for a weak or failed state to graduate from this period of capacity-building, and become eligible for larger scale aid? Is capacity-building really effective in building strong imbedded institutions? Degnbol-Martinussen and Engberg-Pedersen (2003: 270) stress that capacity-building in some instances can seem paternalistic, as it may imply that the donor has superior knowledge of what is needed for development, and what is best for the recipient. With technical cooperation, recipient ownership is usually quite low. This is confirmed by the fact that the policy advice from the international financial institutions is rarely heeded in developing countries.

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8 Such as Zimbabwe, Belarus or North Korea. In some cases, however, these regimes label foreign aid NGOs as western spies and expel them from the country.

NGDOs and limited aid in the form of capacity-building are clearly not enough. New and innovative methods are needed for cooperation with failed states. The European Community, for example, is continuously working towards new methods for sustaining the aid relationship in failed states, even after a break in official ties (European Commission 2005: 90), albeit these new methods are yet to be seen. According to a recent joint declaration by the three main European Union bodies (The European Consensus 2005: 8):

> The EU will improve its response to difficult partnerships and fragile states, where a third of the world's poor live. The EU will strengthen its efforts in conflict prevention work and will support the prevention of state fragility through governance reforms, rule of law, anti-corruption measures and the building of viable state institutions in order to help them fulfil a range of basic functions and meet the needs of their citizens. The EU will work through state systems and strategies, where possible, to increase capacity in fragile states. The EU advocates remaining engaged, even in the most difficult situations, to prevent the emergence of failed states.

Not much attention has been paid in the aid literature to conflict management and conflict prevention, although they are an important avenue for helping failed or weak states. One can hardly dispute the fact that peace and stability are prerequisites for development. In failed states some form of conflict already exists: regional insurgency, guerrilla warfare or outright civil war. In weak states, the eruption of military conflict is a much higher risk than in other developing countries, as dissatisfaction with the ruling elite can be widespread. The losers from reform can also have strong incentives to revolt against the government.

So far, the record of conflict management by the international community is quite dismal. Response is usually late or insufficient (such as the recent case of Darfur in Sudan), and intervention by the United Nations can only put an end to violence, but not solve the underlying problems (such as in Bosnia). Intervention also raises many legal and moral problems, the discussion of which is beyond the scope of the current paper. It is imperative therefore that the focus of the international community shift from conflict management to conflict prevention wherever possible. The costs of conflict prevention are considerably less than the potential costs of civil war and of the peacekeeping operations that may follow, not to mention the unquantifiable cost of human lives. Monitoring stress and instability in various weak states, and formulating appropriate and timely solutions would therefore save a great amount of money, and spare many from even greater hardships. Collier and Hoeffler (2000) argue that the indirect effects of aid, such as starting economic growth and policy reform, can lessen the risk of civil conflict in the long run. If, however, aid fails to achieve these goals and contributes instead to sustained weakness, the reverse is possible. However, in the short run, policy reform can potentially lead to conflict through the redistribution of incomes.

Therefore, new special forms of aid, aimed specifically at conflict prevention and tailored to the context of weak states should be devised. Internationally sponsored active mediation between the government and dissatisfied fractions can achieve results, but mediators must have access to resources with which they can reward compliance. Channelling special forms of aid directly to dissatisfied groups (through NGDOs, for example) may also play an important role in preventing conflict. By smoothing conflicts between the government and potential losers of reforms, donors can greatly contribute to creating an environment suitable for growth-oriented policy reforms.

4 Conclusions

In its current form, policy-based selective aid allocation does not help failed states overcome their internal troubles and to become reintegrated into the international system. It is not a disputed fact that a good policy environment is needed for aid to be effective, and that donors have a strong interest in spending the funds financed from their taxpayers money efficiently. Fulfilling good policy requirements in the sense implied by the CPIA of the World Bank and the MCA of the United States can mean problems for failed states as well as some weak states. Implementation of some of the policies aimed at growth and better absorption of aid funds can create winners and losers, and if the state is weak the potential losers may have the power to block these reforms and potentially cause conflict. This is a fact that must be taken into account when formulating policy criteria for aid allocation.

This paper has summarized two recommendations for integrating failed and fragile states in the international development cooperation regime. One is related to altering our definition of good policies to include policies that compensate the losers of growth-oriented reforms. Losers can form a roadblock to reforms, especially if the state is weak. Donors should require recipients to formulate policies that provide social safety nets, lessen the hardships of the poor with subsidies, and help domestic enterprises become more competitive in order to increase employment, and donors must help recipients in these efforts. Of course, in the long run, the main policy goal has to be the establishment of working markets and ensuring that the effects of growth trickle down to the poorest.

The second recommendation has to do with helping failed states become capable of formulating good policies. In addition to providing technical assistance and limiting the suffering of the population through NGDOs, donors have to take active steps to reduce the possibility of conflict, or help put an end to existing violence. Conflict prevention, conflict management, and peacebuilding have to play an increasing part in development cooperation, as countries in a state of instability or outright war do not have the capacity to formulate good policies and be eligible for large-scale development aid. Groups dissatisfied with the outcome of reforms must also be pacified.

It must be noted that there is no single ‘good policy’. Growth and development in particular are highly context-specific issues: the environment, history, traditions and homegrown institutions of a country make each case different. Another problem is that starting growth may require greatly different policies than sustaining it (Rodrik 2003). Luckily, it seems that the Bretton Woods institutions are recognizing that there is no ideal universal policy for generating and sustaining growth, as shown by a recent report by the World Bank titled *Economic Growth in the 1990s: Learning from a Decade of Reform* (2005b). Of course, formulating highly context-specific policy advice is a much more time and resource consuming task for the international financial institutions, or other donors, for that matter. But at least the fact that the World Bank is beginning to acknowledge that there is no single ‘good policy’ is a step in the right direction.

It remains for future studies to establish how effective policy-based selective aid allocation is and to verify whether, as a result, the quality of policies and institutions in developing countries is actually increasing.

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