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Fragile African States: What Should Donors Do?

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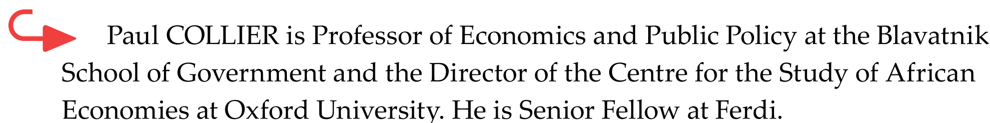
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1. Introduction

Necessarily, all donors will focus increasingly on fragile states. The more successful countries in Africa have achieved growing tax bases and are consequently now gaining access to global capital markets. For such countries, aid is becoming marginal. In contrast, fragile states, by the nature of their condition, have small tax bases and face risks which deter private capital: for them aid remains potentially important. Not only do donors provide a substantial proportion of government revenues; they bring expertise which is sorely lacking in fragile states; and they change incentives for government both intentionally through the conditions they set, and unintentionally through the revenues and expertise they provide.

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... / ... Donor practices have evolved considerably over recent decades. Donors have gradually learned how to operate effectively in those states which have governments that are reasonably representative of the interests of their citizens, and reasonably competent in managing public spending. In such states budget support free of policy conditions is likely to be the most effective modality for providing aid. Government ownership of an aid program maximizes the benefit from the superior local knowledge that it has, and minimizes interference in the accountability of government to citizens. Unfortunately, fragile states are not usually characterized by the combination of governments that are reasonably representative of the interests of their citizens, and reasonably competent in managing public spending: if they had both of these characteristics they would probably not be fragile. Yet without these characteristics, unconditional budget support is liable to be ineffective and can easily be counterproductive. Donor money is unlikely to be well-spent and can undermine the capacities that the state needs to develop. Donors therefore appear to face a dilemma. If the neediest countries are those in which aid is least effective, in allocating aid between countries the donor is faced with an uncomfortable trade-off between need and effectiveness.

The solution to this apparent dilemma follows from the Tinbergen Rule, which sets out the fundamental logic of the attainment of policy objectives by policy instruments. The rule states that for objectives to be attainable there must be at least as many policy instruments as objectives. If the only donor instrument is the volume of aid then the objectives of responding to need and effective use of donor money cannot both be met. Either money can be well-used in environments which are less needy, or it can be channelled to the most needy where much of it will be misused.

In this paper I propose a way out of the donor dilemma. Donors need to develop a suite of instruments which can improve the effectiveness of aid in fragile states. Of course, donors have been trying to do this for decades. But the conventional approaches of *capacity-building* and *policy conditionality* have been ineffective. Capacity-building is indeed needed in fragile states. But it has been going on for decades without being effective. To be effective it has to be linked to the incentives to acquire capacity whereas to date it has been supply-driven. In contrast, policy conditionality is inappropriate: governments that do not wish to implement particular donor-favoured policies are usually adept at either avoiding or neutralizing them. Even where it is apparently successful, policy conditionality undermines the accountability of government to citizen. Government has to be clearly responsible for the policies that are adopted.

This paper proposes a menu of donor interventions that could address two of the salient causes of fragility: low-capacity in government, and isolation in the economy. However, fragile states differ one from another and fragility can have many causes. There is unlikely to be any single donor approach that can address all the varying causes of fragility. Indeed, some fragile situations are probably intractable to any feasible donor actions. In Section 2 I briefly review the various causes of fragility. In Section 3 I propose new donor instruments which could address the major economic cause of fragility, namely isolation from markets. In Section 4 I propose new donor instruments

which could address the major government cause of fragility, namely weak capacity to perform core functions.

1. Causes of Fragility

Fragile situations may arise for several different reasons only some of which are even potentially amenable to donor interventions. Broadly, if a country is fragile then something is wrong with the economy, with the society, or with the government. The focus of this paper is on donor interventions rather than on the causes of fragility, hence this review is necessarily brief. Its purpose is to suggest where donors can and cannot be helpful.

The economy as a source of fragility

The economy could be the source of fragility due to a very low level of income, an endowment of valuable assets that can be looted, or to extreme volatility.

Low income may cause fragility if the tax base cannot provide sufficient revenues to finance adequate security. This is the context in which fragility can be self-perpetuating. However, during the past half-century most countries have been able to develop economically. If neither the society nor the government are themselves impediments to development, pervasive poverty is likely to be persistent only in the context of severe isolation (Collier, 2013). South Sudan is an example of an economy so small and isolated that it is likely to find development very difficult without external assistance. If this is the cause of fragility, aid can potentially enable the country to escape the trap. Aid-financed investment may be able to raise incomes to a level at which fragility has diminished sufficiently for autonomous growth to be self-sustaining. Rwanda is perhaps the clearest case in which big aid has raised growth and that this in turn has successfully reduced fragility. As a pan-African organization, the AfDB is also in a good position to promote regional integration, both of transport infrastructure and the trade and behind-the-border policies that complement physical infrastructure.

Valuable natural assets that can be looted create high returns to private organized violence. Several African countries have suffered from such fragility, such as Sierra Leone and the Niger Delta. If this is the source of fragility then aid is not the right instrument. Directly, the problem is of inadequate security provision by the government, but donors would be uncomfortable with directly financing an expansion of the military budget. International military support through various routes may be necessary. A complementary international effort is to close off market access for looted resources: the key instance to date being the Kimberley Process for diamonds.

Extreme volatility can arise from a variety of shocks: commodity prices, climate and disease. Shocks can create desperation and mass movement of peoples. In principle, aid can be designed so as to cushion commodity shocks but in practice mechanisms have always proved far too slow. A more effective cushion is provided by remittances: mobile phones can be channels for the rapid flow of information between migrants and their families and, when linked to e-payments systems, for

transmission of money. A DFID grant initiated the e-payments mechanism in Kenya, and there may still be a role for donors is promoting its rapid spread around the region.

The society as a source of fragility

The society itself might be the source of fragility. People may identify with polarized groups rather than with the nation. Or they may be so diverse, and have so little trust in each other, that they are unable to cooperate to provide or maintain public goods that are essential for development. Over the long term there is much that government can do to increase social cohesion. The contrast between ethnically similar regions of Tanzania and Kenya illustrates that sustained effort to promote national identity can work (Miguel, 200X). Donors can support and advise, but in the absence of government action there is little that donors can do. If core identities are sub-national then both donors and government need to recognize that the provision of public goods through a national civil service is unlikely to work as well as in more cohesive societies. Alternative designs for public service delivery may be appropriate and the donor can assist the government in experimenting with them.

The government as the source of fragility

The government may be the source of fragility. At one extreme it may be predatory on part of the population, thereby provoking opposition from its victims, and challenges from those who want to seize the government in order to adopt the same strategy. Or the problem may not be the intentions of the government but rather its ability to implement its objectives. In either case it may be unable to provide the public goods essential for development.

Donors need to form a judgment as to whether the intentions of government are reasonably well-aligned with the interests of most citizens. One way in which this condition will be met is if the political system is effectively democratic. The governments generated by such a system have little choice but to follow the interests of their citizens since they otherwise risk losing office. However, many non-democratic governments appear to be reasonably aligned with the interests of their citizens, while many governments that go through the motions of elections are not seriously at risk of losing power regardless of their priorities. Hence, whether this condition is satisfied cannot be determined by a mechanistic rule based on the type of political system, but is an irreducible aspect of donor judgment.

If the government is the source of the fragility due to bad intentions there is little that the donor can do. The donor is not a substitute for domestic political processes of change. Donor attempts to intervene can be counterproductive as domestic political movements for change become perceived as being contaminated by foreign interests. Aid in such situations may have perverse effects. For example, quite generally the amount of repression needed to maintain security is greater the less inclusive is the government. A badly intentioned government wants security without inclusion, but since there is a trade-off and it can only afford a certain level of security forces, it will accept some degree of inclusion in order to reduce insecurity to an acceptable level. If

the donor provides resources which can be spent on the military, the government will find that it has less need to be inclusive. Inadvertently, the donor will have intensified repression and worsened exclusion.

If, however, the source of fragility is that the government is unable to achieve its objectives then there is much that a donor can do. At the core of government ability to achieve objectives is the quality of public financial management. To the extent that this is has been measured since 2005, there has been no overall improvement. This is unsurprising: poor public financial management is not just a sign of a lack of 'capacity'. More reasonably, it should be thought of as an equilibrium reflecting pressures from different interests.

Here, however, there is scope for donor innovation. While overall governance is largely beyond the remit of donor involvement, good economic governance is not merely a matter of political will; it requires specific institutional mechanisms which enable money to be spent effectively. It is at this more practical level that donors can reasonably become involved.

Budget systems have to work in three key respects. First, they have to pass the macroeconomic test of balancing revenues with expenditures. Second, they have to meet the microeconomic test of integrity in taxation and spending. Third, they have to allocate money in such a way that both social needs and public capital goods are adequately provided. These essential features of budget systems require rules, norms, habits and incentives that shape the behaviour of those who take and implement the myriad of decisions on which outcomes depend. There is no simple mapping from rules and incentives on the one hand to habits and norms on the other. Rules and incentives only translate into functional behaviour if they are appropriate for context. Some of the designs which were historically effective in the imperial countries have proved to be dysfunctional in fragile states. They were transplanted during colonialism and enforced by imperial power. Post-independence, while the rules and incentives ostensibly stayed the same, norms and habits often gradually changed. As a result, the inherited systems are now dysfunctional: beneath a veneer of institutional similarity of budget systems, actual behaviour in fragile states is radically different from that in the OECD.

To establish new and more functional norms and habits within budget systems that break the dysfunctional equilibrium, fragile states need distinctive designs of rules and incentives. Designing effective rules and incentives is a complex and demanding task. By definition, the governments of fragile states are ill-equipped to undertake this task, lacking both the skills and the confidence required. Self-evidently, donors can neither substitute for government nor coerce governments into change. However, they can offer governments pertinent skills, knowledge of experience elsewhere, and, by subjecting themselves to rules, they can thereby make aid part of the incentive system. In principle, international skills and experience could be provided independently of aid agencies. For example, the governments of fragile states could hire it in from consultancy companies or universities. However, donors have one huge advantage: since they provide governments with money, they are necessarily implicated in the budget systems they finance.

2. Strategies for private sector diversification in fragile states

Most fragile economies are both isolated and small. This is a distinctive aspect of their economies which constrains their scope for the diversification of private economic activity. The governments of fragile states generally lack the resources to break out of the trap of being small and isolated. Hence, for the economy to develop, donors need strategies which address this distinctive constraint: they must help the country to break out of isolation but this break-out itself requires private investment that may not be forthcoming without donor action. I first set out why private investment in fragile states is distinctive: because much of it involves pioneering, it generates externalities and so is insufficient. Based on this analysis I then turn to the scope for donor action.

3.1. Why private investment in fragile states is distinctive

Isolation is sometimes because fragile states are landlocked and dependent for access to global markets on neighbours that have not provided adequate transport infrastructure. Other fragile states are coastal and potentially integrated into the global economy, but have inadequate transport logistics. Isolation is greatly aggravated by the small size of economies: the domestic market is tiny and the global market inaccessible. South Sudan is an example of such an economy. Activity is dominated by pastoralists, generating a low level of income. The country is extremely isolated: the route north through Sudan is periodically cut off due to political tensions, and the route south depends upon unpaved roads to reach the neighbouring countries of Uganda and Ethiopia, which are themselves small economies that are landlocked with very high transport costs to global markets. Because of these extraordinary circumstances South Sudan is a useful paradigm, but other countries such as Sierra Leone, Liberia and the Sahel have these fundamental features of being small, pre-modern and isolated. The growth process in such economies is fundamentally different from that in integrated economies, and so calls for distinctive donor policies.

Like South Sudan today, 18th century Britain, was also predominantly small and isolated. Adam Smith witnessed the emergence of the modern economy alongside the traditional economy. What struck him most powerfully were the scale economies that came with specialization as the artisanal mode of production was superseded by factories. This is one key aspect of the contrast between the pre-modern economy and the modern economy. The early stages of reaping scale economies permit staggering increases in productivity. Soderbom (2012) studied productivity in Ethiopian manufacturing, and found the same pattern that had impressed Smith. The productivity of workers in firms that had 50 employees was *ten times* that of workers with 4 employees. Of course, a firm with fifty employees remains very small in comparison with how most workers are organized in a modern economy, but in small, isolated economies most of the labour force is not even in firms of this size: it is self-employed in one-person enterprises.

Market size matters not just in respect of ability to reap scale economies in production, but in respect of the intensity of competition. Competition forces both static and dynamic gains in efficiency through discipline and selection effects. Where the market is too small the economy

faces an unsatisfactory trade-off between having insufficient firms to support a competitive market, and having a larger number of firms that are each too small to reap scale efficiencies.

A second feature of the modern economy is a consequence of advanced specialization and so was only in its infancy at the time of Adam Smith, namely the inter-dependence of activities. In the pre-modern economy each enterprise, though tiny, is virtually self-sufficient. It produces a product with no inputs other than capital and labour. This characterization of production: an output produced under constant returns to scale by capital and labour, remains the workhorse model of elementary economics textbooks and it is for some purposes a reasonable description of the pre-modern economy. But as a characterization of the modern economy it is misleading. For example, modern manufacturing is increasingly characterized by intense specialization -'trade in tasks'. The typical firm buys in a wide range of material inputs, undertakes one stage of transformation, and sells its output to another firm which, in turn, uses it as an input into its own process of transformation. Indeed, in the modern economy much of the capital that a firm uses in the production process is hired in rather than owned: buildings are rented and equipment is leased. Hence, the flow of services from capital is conceptually simply another material input. Further, the share of labour in the cost of the firm's output is often small. While production in such an economy is not well-characterized as being dependent upon capital and labour, it is highly interdependent: in the limit every activity depends upon every other activity.

Africa's fragile states have neither scale nor interdependence: typically they consist of smallholder agriculture or pastoralists, plus an extractive sector which operates as an enclave. In the limiting case, transport costs for all the products of the modern economy are initially prohibitive. This was, in effect, the Britain of Adam Smith: the modern economy existed only in the future and its products could not be transported from that future to Smith's era. Smith's economy could only grow by the process of building, activity-by-activity, components of the modern economy. The growth process in Smith's time is conventionally portrayed as being one of a sequence of innovations. But this sequence was arguably less the result of random inventiveness than that sequence of new activities which was pre-determined by what the market could utilize. There was simply no point in inventing the internet in the late eighteenth century, because none of the activities that such an invention needs in order to be useful were then available. This, rather than the slow pace of invention, may have been the real constraint upon the growth process. Indeed, not only the internet, but none of the activities that constitute a modern economy was initially feasible. The sequence of ascent to the modern economy was by way of a host of activities that were essential as stepping stones but which then became redundant: the sinews of the nineteenth century industrial economy were such things as candles, ropes, wooden ships, coal and iron.

Why isolation constrains the opportunities for investment

Now consider how such a country develops into a modern economy. One path is that the economy develops by ceasing to be isolated. Transport costs are radically reduced through investment in transport logistics as a result of which it becomes a normal part of the global modern economy.

Firms and households simply import all those goods and services that cannot be produced at world standards of efficiency. Such a globally-integrated small economy will be highly specialized in a few activities, importing most of its needs. Dubai is an example.

However, investment in transport logistics may not be privately profitable. This may be because many of the returns to the investment cannot be captured by the investor. Or the impediment to private investment in transport may be a lack of coordination between transport investment and other investments. The return on investment in transport may be endogenous to the development of the economy. Like other modern activities, the productivity of transport depends upon its scale of operation and the availability of the many inputs on which it depends. Only if many other investments occur will investment in transport become profitable.

It is also entirely possible that even if all returns could be captured by the investor, they may not be high enough to yield a competitive return on the investment. For example, nothing guarantees that the huge investment required to integrate South Sudan into the global economy would ever have a high return. The market-driven growth process of the nineteenth century achieved integration of the population into the modern economy predominantly by migration: people moved from the pre-modern rural economy to the modern urban economy, often located in a different country.

Hence, while sufficient investment in transport may overcome isolation, there is no guarantee that this investment will occur through the market. Further, it the logistical problems are in part a result of mis-governance, they may not be possible to overcome by private investment in transport.

Now consider the alternative path in which the economy remains isolated. Its only route to development is by the gradual addition of modern activities that expand the range of goods available, and increase the size of the national market, enabling scale economies to be reaped. However, although a fragile state initially has little private capital, the return on private investment need not be high. Returns are dragged down by the inability to reap scale economies and the inability to access inputs that are critical for many activities. It is the combination of scale and interdependence that is the problem. Interdependence alone could be resolved by investing in a miniature version of the global economy. But the economics of Lilliput does not work because of the minimum threshold size required in many activities for reasonable productivity. A corollary is that however abundant and cheap labour might be, capital may be less productive than in the modern global economy.

Consider activities ranked on two criteria: ascending logistical costs of purchasing on the international market, and ascending foregone scale efficiencies if demand is met by local production. In fragile states many goods and services will be too costly to import yet also too costly to make domestically: hence, they will be unavailable. Non-availability has knock-on effects for domestic production. Virtually all activities have some inputs that are critical to their production. If any of these inputs is unavailable then the activity is domestically unviable. In turn, if the logistical

costs of importing this good or service are prohibitive then it joins the category of goods that cannot be supplied.

The distinctive feature of growth in fragile states is that vast tracts of economic activities that are normal in larger economies are missing. As a result, the growth process is mainly driven by the addition of new activities. By definition, the addition of new activities requires a pioneer investor. If successful, the pioneer both widens the range of goods that are available, and increases market size, enabling other firms to reap scale economies. These favourable externalities make further pioneering feasible. If continued growth to the stage of becoming a modern economy is feasible through such a process, and it may not be, it is by means of a sequence of additions to the range of activities achieved by successive pioneers. The growth rate of a fragile state is therefore dependent upon pioneer investors.

The sequence in which activities were accumulated was a concern of an early literature in development economics which analyzed import substitution through 'backward and forward linkages'. A market-driven selection of investments will start with the production of final consumer goods and progress to their inputs: the process of 'backward linkages'. For example, in South Sudan one of the very few modern economic activities is a brewery. In the context of small markets, development through backward linkages typically rapidly runs out of steam: there may be no viable backward sequence in which each new investment is privately profitable that develops a modern economy of sufficient size productively to absorb the labour force. However, from the perspective of the social planner (who internalizes the externalities of interdependence), sequences involving some 'forward linkages' may be more efficient: initial losses suffered by one activity may be more than offset by subsequent gains in other activities. While market-based sequences necessarily ignore externalities, the record of development planning is also discouraging: the enhanced scope to internalize externalities is offset by the scope for political abuse of investment decisions. If public intervention in the investment sequence is envisaged, then some principle must be adopted that bounds the errors.

Since the sequence of private investment is from final consumer goods backwards, those investments that leapfrog to produce those inputs that anticipate demand will depend upon public finance. This has implications for the return on both private and public investment. Despite the small private capital stock, the return on private investment would not be high. Assuming that capital markets were sufficiently integrated internationally, the return might be equated with that elsewhere, but this would occur at a modest level of investment. Conversely, despite the lack of public capital, the return on public investment would initially be below that on private investment: public investment would be leapfrogging into activities that would only subsequently generate an adequate return. That is, the rate of return would be low but would rise with the level of development. A recent empirical study by the IMF, which attempts to estimate the rates of return on private and public capital country-by-country, finds just this pattern (Lowe and Papageorgiou, 2012). The return on private capital appears to be fairly equal across different levels of

development, but the return on public capital is very low in poor economies, but rises with development, becoming markedly higher than that on private capital.

The distinctive prominence of the pioneer role in the growth process in fragile states matters because the impediments to pioneering are significantly more severe than the entry of new firms into already-established activities.

Pioneer Investors in Fragile States and Information Externalities

Pioneers face high costs of information. Firms that pioneer activities where the product or services is initially missing (the fourth category) face two gaps in information: the extent of the domestic market, and the costs of domestic production. Those that pioneer activities where the product is initially imported at high cost also face the second of these costs, but not the first.

Both types of pioneer lack the information which is normally inadvertently revealed by the presence of existing enterprise: the activity must be commercially viable. The unknown is normally whether the new entrant will be competitive with the existing entrants. Conversely, all pioneers have the information that the absence of any existing enterprises may indicate that the activity will prove to be unviable. In developed countries pioneer activities are defined in terms of the product or service produced: new products and services are difficult to assess and so costly information is generated through market research. Even so many new products and services fail. In contrast, in fragile states the frontier is not defined by the novelty of the product or service, since this is invariably standard in more developed economies. Rather, it is defined by the local context: an enterprise needs markets for its inputs and outputs. Its viability will also be affected by the costs of transactions, the extent of regulatory impediments, and distinctive aspects of local geography.

In a fragile state there is no automatic supply of pioneer investors. Such investment faces impediments that are an order of magnitude more severe than investment in established activities. Pioneer investors are either local firms experimenting with a new product or service, or international firms experimenting with a new market. I consider them in turn.

By definition, local enterprises are not engaged in the activity and so do not know how to produce it. Nor do they know whether they can sell it. In the case of imported manufactures knowledge of market is relatively straightforward: the importer is in a position to understand demand. By extension, products and services that are neither imported nor produced but are genuinely missing pose daunting information problems. In developed countries sophisticated market research can reduce the information gap, but in frontier markets such research is itself one of the missing services.

Even if a local firm overcomes the obstacles of a lack of information about both the market and production methods, it will need to raise the finance for a high-risk investment. Financial markets in frontier economies are among those activities that are highly truncated, so that the supply of high-risk capital for pioneering enterprises is very limited. Essentially, firms will need to self-finance.

Yet there are few large domestic firms and so few have the scale of internal risk finance needed for pioneering.

Now consider international enterprises that are already experienced in the activity. The obstacle facing these enterprises is a lack of knowledge of the local context of markets for inputs and outputs, infrastructure, transactions costs and regulation. Can workers of sufficient calibre be recruited at a viable wage rate? Will new suppliers enter the market to provide the firm with critical inputs? Will logistical choke points such as ports be reliable, or will they attract rent-seeking hold-ups? Will buyers be willing to rely upon this new source of supply? Do employees face dangers for which the firm will be held responsible? By definition, the only reliable way to get all this information is to undertake the investment. If the enterprise fails then the value of the investment will decline catastrophically. Not only will the enterprise itself have been demonstrated to be unviable, but the markets in second hand equipment and buildings will be very thin. Further, the firm is unable to limit its losses to its investment. To establish the enterprise the firm will need to send its own staff to work in it, and the firm faces the potential liability of any harm that may befall them.

At the core of the problem of pioneering are the difficulties created by the inter-dependence of activities. If one activity is unviable then all the downstream activities that are dependent upon it are also unviable. This creates a chicken-and-egg problem: the lack of demand for an input makes its supply unviable, yet the lack of supply of the input makes demand for it unviable. Where this obstacle is simply a matter of a single bottleneck input needed by a single downstream firm then the coordination problem is not particularly daunting. A new entrant can coordinate its decision with its supplier: for example, even in a thick-market developing economy such as China, Swedish firms that off-shore production to meet Chinese demand arrange for their Swedish suppliers to relocate with them. Alternatively, a firm may opt for vertical integration, doing in-house tasks that in conditions of thicker markets would be bought-in. For example, James Berger, a German company that is the largest construction firm in Nigeria, (also a thick market by the standards of most African economies), not only operates its own transport fleet, but retreads the tyres used by its lorries rather than buy-in retreading services from other firms.

A corollary of a lack of information and the inability to coordinate across multiple actors is an inability to estimate risk. Until there is a population of firms in the pertinent context (infrastructure, markets and policy), then risk cannot accurately be assessed. If risks cannot be known then they are liable to be exaggerated. The primary purpose of information about risk is to place bounds upon it. In the absence of information risks cannot be bounded and so in standard commercial decision processes, such as an approvals committee, must be assumed to be very high. Unknown risk (i.e. uncertainty), is treated qualitatively differently from known risks. Without a procedural distinction between risk and uncertainty in decision processes that penalizes uncertainty, approvals committees would not be able to provide an incentive for due diligence by those responsible for preparing a project. Decision rules are adopted which are equivalent to exaggerating the risks that are actually faced.

The key information needed to assess the risks of pioneering cannot be generated except by actually doing the project. This is because the key information is not technical but commercial and so can only be generated by actually trying to run an enterprise. If there is currently no such enterprise in the country (or locality), then pioneer enterprises will generate information externalities for subsequent entrants. Since subsequent entrants will face lower risks, they are also likely to have lower costs (since risks to equity owners will have to be compensated). Hence, the pioneer can anticipate that if the investment is successful, margins will be squeezed by competition that takes advantage of the information inadvertently generated by the pioneer. While the pioneer generates positive externalities for subsequent entrants, they generate negative externalities for the pioneer. In pioneering, any first-mover advantage may thus be more than outweighed by information externalities.

3.2. Implications for Aid to Fragile States

The process of economic growth is driven by entrepreneurs taking investment risks with other people's money. This is happening in most developing countries but not yet on a sufficient scale in fragile states. Above I have suggested that this is inherent to small, isolated markets: despite the lack of capital, returns are depressed by the inability to reap scale economies and the absence of necessary inputs, and risks are elevated by the lack of information facing pioneers. The public sector cannot substitute for the role of entrepreneurs: it lacks the combination of information, incentives and skills that makes entrepreneurs pivotal to the growth process. If public activity cannot substitute for entrepreneurship, should it actively induce it by subsidy, or should it simply provide an 'enabling policy environment'? More specifically, should development assistance be used to subsidize private investments in fragile states?

The core critique of such a policy is that if the project is commercially viable without aid then the aid is wasted since it would happen anyway, whereas if it is not commercially viable without aid then it is distorting, luring private investment into activities where returns do not warrant it. The fundamental response to this critique is that private investors and donors legitimately have different objectives. The decision problem facing private investors is to allocate capital globally in such a way as to maximize risk-corrected returns. The objective of donors is to promote the convergence of poor countries to the living standards of the developed economies.

In the absence of aid to subsidize private investment fragile states may not be able to develop. It is entirely possible that the returns on private investment are never sufficiently high to offset the low returns on initial investment. The market solution to the low productivity of people living in fragile states is likely to be for their populations to emigrate, rather than for capital to flow in. Yet the donor may entirely reasonably decide that the right social objective is not to maximize the returns on capital, but to develop the society *in situ*. The depopulation of South Sudan is not an acceptable solution to its problem of poverty. Hence, the same investment can potentially be bad from a private perspective but good from a public perspective. Since neither the donor nor the

government can substitute for private entrepreneurship, if aid is to assist development in a fragile state it must somehow induce private investment.

Option 1: Aid to address isolation

If isolation is the problem, the most direct use of aid to address the problem would be for it to finance connectedness by investing in transport infrastructure. As transport costs fall and the economy becomes integrated into the modern global economy it becomes able to follow the normal pattern of development of gradual economic diversification. However, while infrastructure is necessary to solve the isolation problem, it is not sufficient. Two other factors need to be addressed: complementary government services, and cooperation with neighbours.

Typically more of the time costs of transporting goods to and from fragile states are accounted for by bureaucratic delays than by the slow speed of travel. The delays are deliberate, designed to extract rents from users. Unless this is addressed, improved infrastructure will merely increase the rents that officials can extort for granting permission to transport goods, rather than reduce transport costs. The persistence of bureaucratic corruption at choke points in transport, such as ports and roads, reflects the political power of rent-seeking. If the governments of fragile states want their economies to break out of isolation there is no alternative to confronting these powerful lobbies. Once an infrastructure investment has been made by a donor it cannot be reversed. This creates the potential for a *time-consistency* problem: a weak government has an incentive to promise to face down the lobbies, but once the donor has made the investment it reneges on its commitment. Since donors can anticipate this risk that a huge investment in transport infrastructure will prove fruitless, they are discouraged from making it. The simplest solution to this problem is for the government of a fragile state decisively to face down the lobbies in advance of seeking donor investment in transport infrastructure.

Given that Africa is divided into 54 states it is inevitable that much transport infrastructure will be multi-country corridors. For such infrastructure investments the underlying cause of isolation may be due to a lack of coordination or cooperation among neighbouring governments. Coordination and cooperation is needed not only to build infrastructure but to operate it. For multi-country infrastructure to function efficiently requires the continuing cooperation of all governments: this exposes the investor to a weakest link problem. Further, since any single government can make the investment unproductive, each can potentially exploit the power of hold-up. In combination these features make multi-country infrastructure investments severely *time-inconsistent*: that is, once the investment has been made, each government has a strong incentive to renege on the terms agreed with other governments and the investor *ex ante*. Since both investors and governments can recognize this problem in advance, the result is that such investments are not made because they are too risky. The only solution to a time-consistency problem is for the governments concerned to build a credible *commitment technology*. In the previous time consistency problem discussed above, where domestic rent-seeking lobbies such as customs officers were the source of the risk, a credible commitment technology was straightforward: defeat the lobbies in advance.

However, in the present case the risk comes from the potential for opportunistic behaviour by governments themselves. A commitment technology can thus only be credible if it can create penalties for governments which renege on an agreement that are sufficiently potent that reneging is no longer attractive. The agreement can thereby be trusted by all parties. To date, African governments have not been able to design arrangements that are sufficiently credible to warrant the huge investments that multi-country transport corridors would require. However, the AfDB is well-placed to create commitment technologies both because it is a trusted party, African run but neutral between governments, and because by virtue of its pan-African long-term lending program it can impose and enforce substantial penalties.

Even if transport infrastructure is financed by donors and enabled to operate free of rent-seeking, it is still only a necessary condition for breaking isolation. Many of the costs of transport are endogenous to the size of the market, rather than to the provision of infrastructure. For example, while airport infrastructure is necessary for air connectedness, the network of air routes depends upon what the market will bear. Hence, like other costs, the reduction in transport costs depends upon growth in the overall size of the market. Isolation is reduced consequent upon growth, but this does not prevent growth being stymied by isolation. An implication is that other donor support for private sector development, discussed below, complements investment in transport infrastructure in gradually breaking isolation.

Governments of fragile states will often need donor finance for major transport infrastructure, but currently some of them have an alternative. In many fragile states there have recently been significant mineral discoveries. Such discoveries can create an opportunity for breaking isolation because the infrastructure needed for transporting minerals to the global market can also serve other uses. Typically, mining companies prefer to have dedicated usage of their transport infrastructure: their core mission is extract ore not to run a freight service for other users. Hence, it is important that governments require mining companies to design and operate their transport investments as multi-user facilities (Collier, 2011). Since this will somewhat increase the cost of the infrastructure to the mining companies, there should be an offsetting reduction in taxation. However, the cost to the government in somewhat lower tax revenues is likely to be small relative to the gain to the economy in breaking isolation. If done at the design stage, the extra costs of making transport infrastructure multi-user are far lower than the full cost of building infrastructure from scratch.

Option 2: Aid to subsidize infrastructure

In fragile states private investment will be disproportionately pioneering. Pioneer investment generates beneficial externalities and so warrants public subsidy. The least complicated way of subsidizing such private investment may be indirect. By investing donor resources in infrastructure investments which are not privately viable but which are complementary to much other activity, such as electricity generation, donors raise the return on other types of private investment. The limited extent of private investment in such infrastructure in fragile states suggests that private

returns are too low to attract investors. For example, it is notable that to date despite two decades in which the private provision of electricity has become common both in the OECD and in converging economies, there are no full instances of it in Africa (Eberhard, *et al*. 2011).

While the above has been cast in terms of rates of return on investment, it could equally be presented in terms of risk. For a private investor with a portfolio of options, investment in a high-risk fragile state can be overall risk-increasing and so unattractive. However, the objective of the donor is to develop the country, so the key risk is that it will not develop. *An investment that makes development more likely, even if it is risk-increasing from the perspective of a private investor, is risk-reducing from the perspective of the donor*.

However, donor provision of infrastructure may not sufficiently raise the returns on private investment in fragile states to induce a substantial response. After all, many fragile states had better infrastructure at the time of Independence than they do now, but that infrastructure did not induce private investment. As I have argued above, such a lack of private investment in a fragile state may reflect a coordination problem. The growth process depends disproportionately upon the diversification, or broadening, of economic activity and this is more impeded by market failures than the expansion of existing activities. Growth-promoting aid policies may therefore need to pump-prime diversification, much as in OECD economies governments have generated huge benefits from pump-priming technological innovation (Mazzucato, 2013). The analogy is warranted because in each case the externality of pioneering occurs together with severe information-based impediments to pioneering. Viewed from the perspective of a benign and omnipotent social planner, the return on capital may be maximized by accepting a sequence of investment into fragile states such that the pioneer investments make losses. These investments increase market size and widen the range of available goods, thereby opening up subsequent opportunities for high return investment. The rationale for donor subsidy of pioneering investment is to substitute for the coordination missing in the private allocation of capital.

This raises the question as to whether it is practically feasible directly to subsidize pioneer investment in fragile states. I now consider three potential donor instruments for subsidizing pioneering investment: providing capital at below market rates, providing insurance, and actively partnering on the management boards of enterprises.

Option 3: Subsidizing capital

The provision of capital at below market rates can be through equity or bonds. As between the two, the former has the advantage of being explicitly risk-bearing and so forces a management decision which evaluates the value of the underlying proposition; whereas the provision of bonds encourages a managerial approach focusing on collateral. The latter is akin to the approach that has been taken by commercial banks in making loans, but since pioneer investment unavoidably puts capital at risk, insistence upon collateral precludes the finance of such investments. However, for donors to be able to evaluate the underlying business case for pioneering ventures, they need a different skill set from that found in the conventional development agency. They need two distinct

skills: those of a venture capitalist, able to assess the proposition and management capabilities of a venture – and sometimes strengthen them; and those of a development economist, able to assess the externalities from establishing a new activity for the rest of the economy. In principle, this combination already exists both in the private finance arms of the development agencies such as IFC, FMO and CDC, and in the rapidly growing social enterprise sector. In practice, neither has worked well for pioneer investment.

The public agencies have usually not succeeded in integrating commercial and economic criteria because their investment arms are not financially integrated into their aid budgets. In respect of pioneering investments there is a straightforward tension between commercial and economic criteria: pioneering investments generate externalities which benefit society but not the venture itself. The core role of public finance in promoting private investment in fragile states is to absorb the cost of these externalities. Yet in the investment arms of the public agencies the commercial criteria currently take precedence because the overall private return on the portfolio remains an important criterion of their success. In contrast, the economic criteria have not been integrated into in a broader country-specific development strategy; notably one that treats subsidies for pioneer investment as a component part of overall donor support for a fragile state. For example, there is no mechanism whereby part of the IDA allocation for a fragile state can be channelled through IFC to subsidize the externalities of pioneer investments. As a result, the economic criteria have not been sufficiently potent to override the commercial. An inevitable consequence is that fragile state investment in general, and pioneer investments in particular, have been only a small proportion of the portfolios of the investment arms of the development agencies.

Social enterprise is in principle the equivalent for private charitable finance that the investment arms of the development agencies are for public development assistance. However, in practice social enterprise has been more interested in the potential of microfinance to alleviate poverty, than as a means to support larger-scale pioneer investors through skills and money. Paradoxically, the sector has also mirrored the concern of the public agencies with commercial criteria: an accepted mantra is that social enterprises must rapidly become financially self-sustaining. As with the public agencies, this precludes absorbing the cost of externalities.

Thus, at present neither the donor agencies nor social enterprise provides significant institutional mechanisms for financing the externalities that are likely to be important in the development of fragile states.

In principle, governments themselves can subsidize pioneering investment. Collier and Venables (2012) propose how this can be done in the special case of pioneering commercial agriculture, but since the approach relies upon the allocation of abundant land as an incentive it cannot be generalized beyond this particular sector.

Option 4: Providing Political Risk Insurance

Donors also provide insurance through agencies such as OPIC and MIGA. As with the capital-providing public agencies they face the challenge of integrating commercial and economic criteria, and are not themselves financed on a basis that they can make overall commercial losses offset by social gains. For example, MIGA has not been well-integrated into World Bank country strategies: there is no mechanism whereby an IDA allocation to a fragile state can in part be used to subsidize the provision of insurance to private investors. As a result, insurance portfolios like capital portfolios are skewed away from the countries where they would be of most social value.

Where the public insurance agencies have had remarkable success is with political risk rather than commercial risk. Political risk is important in most fragile states, and may indeed by particularly important for pioneer investments since the extent of vulnerability to political predation in a new activity cannot be well-assessed. However, it does not provide cover for the purely commercial risks of pioneering. Indeed, since many of the unknowns in pioneering are unquantifiable uncertainties rather than quantified risks, there is no basis for insurance: they are best borne by equity capital.

The reason why the donor agencies have been able to provide political risk insurance at below-market rates is that the donor relationship provides some leverage. While the extent of leverage has been grossly over-estimated, notably in the attempts at linking aid to the adoption of economic and social policies, a more modest link to the honouring of commercial contracts has proved to be feasible. Donors clearly have both more access to the higher levels of government than have individual investors, and also more scope for recourse. Thus, MIGA is able to offer five aspects of political risk insurance in Africa's fragile states at a premium of little more than one percent of the sum insured. The reason risk cover through MIGA is so cheap is that it has been able to recover all but one of the many claims on which it has paid out.

Again, the provision of political risk insurance is something that a government with natural resource revenues might itself consider, regardless of whether donors are willing to support it. Since private investment would have evident social benefits beyond the return to investors, subsidizing insurance against the risks of political violence would appear to be a reasonable use of public money.

Option 5: Donor-Business Investment partnerships

By an investment partnership, I mean a long-term arrangement between a donor and a firm through which, subject to government agreement, a series of pioneering investments are undertaken in fragile states. The donor provides sufficient aid to make the venture commercially viable, and the firm commits to using its best endeavours to make the venture succeed.

In its origins, development assistance often took this form. Bilateral aid programs competed with each other to provide subsidies for their national enterprises to win contracts. This was the case not

just for European and American aid, but also for early Japanese aid to China. As the Western donors withdrew from linking aid to commercial ventures in fragile states, so the Chinese have enormously expanded into this form of donor relationship. Indeed, Brautigam (2009) plausibly argues that Japanese aid to China was the model of aid which the Chinese have themselves subsequently adopted in their own aid program to Africa. This model of aid is ethically unappealing and has largely been abandoned in Europe, most explicitly so by Britain which legally requires its aid program to be uncontaminated by ties to commercial interests. This move towards a disinterested rationale for aid-as-charity also shifted the ostensible purpose of aid from an economic to a social agenda, and from bilateral to multilateral institutional vehicles which, by their design, could not give commercial preference.

Nevertheless, despite being ethically unappealing, such commercially linked aid has some striking advantages. The riskiness of an investment is endogenous to the context of the contract. If neither government nor the firm know each other prior to negotiation, nor have reasonable expectations of further deals, then each must presume that the other is liable to behave opportunistically. Hence, the political risks to the firm are objectively high. A donor-as-partner can reduce these risks in several respects. From the perspective of the government, the donor can acquire information about its national firm much more readily than the government, and can more credibly set this particular contract in a context of an ongoing commercial partnership. The donor itself is a known quantity to the government, again with an ongoing relationship, and with some reasonable presumption that the donor is indeed looking for deals that are mutually beneficial rather than being advantageous to the national firm only because they are disadvantageous to the government. From the perspective of the firm, if despite these considerations the government does behave opportunistically at its expense, then the firm can reasonably look to the donor for recourse, and the donor can reasonably pressure the government for it, as demonstrated by the success of the public provision of political risk insurance.

The political risk insurance advantage of investment partnerships is particularly important in the case of infrastructure such as electricity, rail, and ports. In addition to the problem of low initial rates of return discussed above, an overarching obstacle to private investment in such infrastructure in fragile states is the hold-up problem. Once the investment has been made, the government has an incentive and the power to require under-pricing of the service. Governments need, but lack, credible commitment technologies to overcome this time-consistency problem. By being a partner to the contract, a donor with long-term relationships with both government and the firm may be able to make them viable. The donor enters into a tripartite partnership with a firm and a government, each of these other parties having some reason to avoid opportunistic behaviour towards the other, and consequently being able to place more trust in the deal.

Donor partnerships with firms for pioneering investments thus package together the instrument of subsidy and the instrument of partnership. The instrument of subsidy is needed to compensate for the externalities generated by pioneering; the instrument of long-term partnership is needed to address the endogenity of risk to the contractual context.

Such commercial aid also has political advantages. Because the underlying venture, is designed to be mutually advantageous other than for the aid subsidy, it is not structurally patronizing, nor is there an asymmetry of power to be exploited through conditions favoured and imposed by donors (whether economic, environmental, social or political). Viewed from a global perspective, because donor societies benefit to the extent that their aid gains them contracts, competition between bilateral donors would drive aid budgets up, in contrast to the global public good characteristic of multilateral charitable aid which induces free-riding.

3. Strategies for assisting low-capacity governments

Fragile states have public sectors which are not able to perform their tasks at standards appropriate for 21st century living. In this section I consider three functions of the public sector that, because they are inadequately performed, tend to perpetuate fragility. These are the collection of tax revenue, the process of public spending, and the provision of physical security. In each case I discuss the scope for donors to improve the functioning of the public sector through the conjunction of money and system redesign.

4.1. Building Effective Tax Systems

Why tax systems are important for development

The capacity to tax is now seen by development economists as fundamental to sustained growth. The argument is not that tax revenue finances public goods, but rather that taxation provides incentives to both government and citizens that induce growth-conducive policies. Through these influences taxation gradually changes how the polity is organized: how political interest groups shape long-lasting institutions that thereafter affect choices. One influential line of argument is that the key initial condition for prosperity is a structure of political power which is *centralized* and *inclusive*.

The fundamentals of *centralized* power rest on the costs of military control over territory relative to the revenues that can be raised. No unified polity may be viable: the fundamentals of an area's geography and technology may make it uneconomic to control militarily more than a very small area. For example, the Romans decided that North Britain could not sustainably be brought under unified government. Similarly, prior to colonialism no large political units had emerged in Africa. If a unified polity emerges, the next hurdle is whether it is in the interest of political elites to build a tax system. Historically in Europe states needed revenues to finance military spending in arms races with neighbouring states. In turn, a tax system gives a government an interest in enlarging the economy, and so induces it to build the rule of law. *Crucially, the rule of law induces the government to provide secure rights of private property*. Once this is in place people have an incentive to invest, confident that productive assets will not be expropriated. Weak property rights create a wedge between the social and private returns on investment and so can account for the juxtaposition of an acute shortage of capital, with consequent high social returns, and yet low private savings rates. In turn, investment drives growth. In an important new study, Daron Acemoglu and James

Robinson (2012) argue that the English Glorious Revolution of 1688, in which power shifted from king to parliament, was the first such decisive event in world economic history, unleashing the Industrial Revolution and opening the path to global prosperity. Onto this secure base for investment, a further layer of institutions gradually come to address the distribution of income.

For various reasons, even if a unified policy emerges, this benign process of growth may not be ignited because elites find that building a tax system is not in their best interest. The cost of building a tax system may be atypically high, or the benefits from revenue atypically low. Costs may be high because tax collectors would not work in the interest of the state, or because there is a risk that the current elite will lose control so that a tax system would be turned against it. Benefits of tax revenue may be low because the state has other sources of revenue; because the polity is not faced by external threats and so is not trapped in a remorseless drive for more military spending; or because publicly provided services would not satisfy elite preferences.

Centralized states can grow up to point without being inclusive: the elites controlling the state encourage growth because they capture it, but they are predatory ('extractive') on the majority and so most people face disincentives to invest. Hence, the society will not reach a high level of average income. For a state to switch from being extractive to *inclusive* the key institutional change is the shift in political power that protects the interests of the productive from the extractive elite. The tax system may play a critical role in this second transformation. People object to paying tax if they are not represented in the structure of political power: 'no taxation without representation'. Once the state is inclusive we arrive at property-owning democracy. Some states may function in the interest of ordinary people ('common interest' states) even if political power remains with the elite (Besley and Persson, 2011). This can arise if the interests of the elite are sufficiently similar to those of ordinary people, perhaps because the distribution of income is already quite equal and the elite has the same ethnic and religious identity as other citizens. This may, for example, characterize some East Asian countries.

What can donors do to encourage tax systems?

Donors have been providing 'capacity-building' to the tax systems of fragile states for decades. However, this has primarily been aimed at training budget staff in skills rather than on more fundamental design of the rules and incentives in manner that is likely to be habit-changing.

It is important to recognize that the direct effect of donors on the incentive to build a tax system is perverse: the donor is providing non-tax money and so the government has less need to raise tax revenues. Since taxation is universally unpopular with citizens, left to its own decision, a government will rationally choose to spend some of its aid on reduced taxation. If the government is setting the level of taxation so as to equate the marginal benefits of public spending with the marginal costs of taxation, then using some aid to reduce taxation is efficient. However, the political economy perspective implies that there are important benefits of taxation over-and-above any direct benefits of public spending which governments do not take into account, so that tax revenues are set too low. By reducing the need to tax, aid would therefore inadvertently weaken

the incentive for the government to encourage investment through securing property rights, and also weaken citizen pressure for accountability.

It is therefore legitimate for donors to try to offset this adverse direct effect upon taxation by other actions. There are four approaches open to donors that can potentially offset the direct effect: making it easier for the government to raise taxation, reducing the competitive pressures to have lower taxes than neighbours, encouraging redesign of tax administration, and rewarding the government for raising extra revenue.

There is much that donors can do to make it easier for governments to raise taxation. The AfDB is now providing legal assistance for tax design, notably for mining codes. The problem of corporate tax avoidance is far better addressed internationally than by individual fragile states (Collier, 2013a). The OECD is now proposing to create a centralized database of guide prices for salient intra-company transactions, complemented by a support program of 'tax inspectors without borders'. Under the program, inspectors from OECD tax administrations would be seconded to those of fragile states in order both directly to use the new database and to train African tax officials in how to reduce tax avoidance. Such initiatives are highly cost-effective uses of aid.

African governments compete against each other to attract investment. Some of this competition is healthy, providing an incentive for governments to provide a better business environment. But competition on taxation gives rise to a prisoners' dilemma type situation in which governments are driven into a race-to-the-bottom in which they all lose. Fragile states may need to offer somewhat lower rates of taxation than more secure states in order to offset higher risks, but such offsets need to be bounded. Indeed, to the extent that they lead to a generalized reduction in African tax rates they are ineffective. Being pan-African, the AfDB is well-positioned to address this problem. At a minimum it can propose guidelines on floor rates of corporate taxation. It can also encourage sub-regional organizations to promote tax clubs among governments. Subject to collective agreement, it can potentially penalize governments which set taxes below floor rates whether by public shaming or offsetting financial allocations.

Tax administrations are complex organizations. Building them takes time and is therefore itself an investment. Because effective tax organizations have such a high pay-off, both financially in terms of tax receipts and socially through their incentive effects, the finance of this investment is highly appropriate for aid. Further, because it is complex, it is appropriate for substantial technical assistance, not just at the day-to-day operational level discussed above, but at the design stage.

Building effective tax organizations in fragile states is particularly complex because corruption is usually endemic, so that tax officials face very strong temptations to accept bribes in return for conniving at tax evasion. Resisting these pressures requires sophisticated organizational design. Donors have long-recognized this need: the most important exception to the donor emphasis upon training was the creation of Independent Revenue Authorities. Whereas in the OECD revenue collection normally comes under the Ministry of Finance and the administration is within the civil service, in fragile states the tax-raising function has usually been hived off into a new organization.

This had various advantages. Recruits for the IRA would be newly hired, so that there was an opportunity to weed out the least effective staff. Employees could be faced with new rewards and penalties distinct from those in the civil service. Because the change was not incremental, there was some prospect that expectations would not be set by past habits.

Recent research in the economics of organizational effectiveness has shifted emphasis on how to motivate staff from incentives to the internalization of objectives (Akerlof and Kranton, 2011). An effective organization devotes resources to selecting recruits who are likely to share its objectives, and thereafter to building their commitment. With a tax organization this is doubly difficult. The people most attracted to becoming tax inspectors are liable to be those eager to reap personal rewards from corruption. For example, in Madagascar potential recruits to the school for customs officers are reputedly willing to pay $15,000 as a bribe to gain admission. Such recruits are unlikely to become good customs officers. In contrast to the evident personal opportunities, the national importance of taxation is not automatically apparent: it needs to be explained step-by-step. In effect, a cadre of tax inspectors needs to be built that is the proud embodiment of national aspirations and this is a task which requires good and sustained leadership. Just as officials can be motivated, so taxpayers can to an extent be made to feel proud to pay and feel ashamed of evasion. In Pakistan a recent experiment in which major taxpayers gained public recognition succeeded in increasing revenues. In Lagos Governor Fashola has persuaded taxpayers to recognize the connection between paying the taxes due to the improvement of public services.

Finally, donors can potentially reward tax effort by linking it to aid. IMF programs have often made this link by requiring revenue to rise as a proportion of GDP by a certain amount each year. One possibility is to use similar commitments to strengthen sub-regional tax clubs, so that in addition to common floors governments would commit collectively to a path of increased revenues. Recall that all four of these approaches are legitimated by the need to offset the direct effect of aid to reduce tax effort which is in turn detrimental to long term development.

4.2. Strategies for assisting low-capacity governments: reinventing public spending systems

No fragile state has an adequate system for public spending. Among fragile states I focus on a subset: namely those in which the government is at least adequately aligned with the interests of its population, whether through a functioning democracy, or a benign autocracy. I will assume that the government, or at least significant parts of the government, recognizes that is sits atop a public spending system in which dysfunctional practices are well-entrenched. It is therefore willing to discuss with donors new approaches to public spending as long as they are both effective and politically realistic. What, other than capacity-building as usual, should a donor propose? I suggest three new mechanisms. One is designed to change the incentives for reform in the existing public spending system, the other two are new public organizations designed for specific aspects of spending. Although they can be adopted individually, they also form a coherent package.

Reforming the Public Spending System: Independent Ratings

An independent process of scrutiny is needed to rate whether a public spending system is fit for budget support. Currently, no international agency has all the skills and staff necessary for the rating function. The IMF comes closest with its Public Expenditure and Financial Accountability (PEFA) Program, but this has two critical deficiencies. While it considers system design, it does not investigate how money is spent in practice. That is, it lacks an audit function. The *ad hoc* Public Expenditure Tracking Surveys (PETS) of the World Bank perform such a function and so could be extended, or the international accountancy firms could conduct external audits as part of an augmented PEFA. The other deficiency is that the PEFA does not provide an overall rating system tied to donor behavior. The principle of a link from an independent assessment to a donor rule of behavior is long-established: the existence of a Fund Program is a near-universal condition for development aid. The analogy with a budget system rating would be to make a threshold level of the ratings a condition for sustained budget support. The evident analogy here is with the credit ratings of governments issued by the rating agencies. From these ratings a particular threshold has been widely adopted which determines whether the bonds of a government can be held in portfolios. As with these credit ratings, the entire range of ratings would be useful rather than just the threshold certification. In particular, for those budget systems which did not meet standards adequate for budget support it would show both governments and donors how far off was the system from the required standard, and hence whether the realistic response was incremental improvement or systemic redesign.

Those countries that gained certification for their budget systems would have a much stronger case for budget support. Those governments of poor countries that are aligned with the interests of their citizens and administratively equipped to meet those interests should be empowered by aid rather than pestered with conditions. Why should donors fund their favored projects, or bypass the government through NGOs, when money could safely be channeled through the budget? Correspondingly, donors would find budget support easier to grant in these cases because the decision would be politically protected by the authority of an external rating. Those countries that did not meet certified standards could have a grace period to get their systems in order, supported by technical assistance. Presidents would likely pressure their governments into doing what it took to achieve certification. Would this be a backdoor return to policy conditionality? Decidedly not: the purpose is not to tell governments on what to spend their money, but to strengthen the enforcement of their own laws. Nowhere is looting of the public purse an official policy.

One reason why donors are wary of certification is that with rare exceptions the budget systems of fragile states would not currently meet any reasonable standard: yet without a budgetary infusion there is a risk of state collapse. The rationale for support here is not ‘budget support’ but ‘life support’, to avert the staggering costs of state failure. Life support can make sense, but donors should handle it entirely differently from budget support. The use of the same vehicle, and indeed the same term, for the two situations has both exemplified and deepened donor confusion: if fragile states are eligible for *budget* support, every country is eligible. Once fiscal support in these

situations is distinguished as 'life support' the rules of engagement can also be distinguished. Life support should come with sufficient imported administrative capacity immediately to achieve proper standards of public spending, not just of donor money but of all public money (donor spending cannot, in reality, be separately identified). Unlike technical assistance to prepare for budget support, imported administrative capacity would have an explicitly dual objective: not only to build local capacity in the longer term, but to substitute for its current deficiencies, thereby preventing public money from being looted. As Paddy Ashdown said of Bosnia, what was needed was not 'doctors without frontiers' so much as accountants without frontiers.

But the major reason why donors are wary of ratings and certification is that they realize that in many fragile states budget systems are not fixable within a reasonable time frame. After the grace period, if the rating was still below the threshold then budget support would be tapered out. Donors are rightly reluctant to subscribe to a policy rule which would appear to imply that the allocation of aid to needy countries would be curtailed. Hence, it is essential to complement the introduction of budget ratings and 'life support' with the introduction of other modalities for aid delivery such as those proposed below.

Enhancing the Delivery of Basic Social Services:Auxiliary Public Service Agencies

Donors can encourage and assist in the redesign of the organizational structure of public service provision. They can offer to channel their aid through a new system, thereby providing insurance against inherited public spending systems remaining below the minimum threshold required for budget support. Aid budgets to fragile states could remain high even if traditional public spending systems were judged inadequate as reliable channels for public money.

The standard model of public provision of basic services in fragile states is reflects the colonial inheritance. Ministries of education and health perform the three functions of planning, resource allocation, and the direct management of schools and clinics. The nature of the problem currently facing this approach can be illustrated by two examples. In Chad, which is a fairly typical fragile state, the PETS found that only one percent of the money released by the ministry of finance for rural clinics actually reached the clinics. The second example is a scandal from Zambia, where governance is considerably above that in fragile states (which is why the scandal came to light). Following the provision of international aid for antiretroviral drugs the chief civil servant in the Ministry of Health established his own private company to import fake drugs from Eastern Europe which, in his capacity as a public official, he purchased. These disturbing examples are symptoms of a more general problem of staff motivation.

As discussed above in the context of a tax administration, recent evidence from Akerlof and Kranton (2011) argues that in many occupations worker motivation is achieved not by financial incentives but by worker internalization of the objectives of the organization. While this is common even in commercial organizations, it is all the more applicable in the public sector. Typically, activities are in the public sector because they are unsuited to high-powered incentives (for example, individual staff performance is difficult to monitor), while being intrinsically satisfying

because of their human interest (such as teaching children or healing the sick) or serve a national mission (such as the military). Around the world this is how the civil service is usually run: public servants internalize the mission of the organization. The system is normally self-perpetuating: new recruits adopt the norms of an organization, partly due to purposive training by the organization, partly due to conscious imitation of existing employees, and partly due to sub-conscious imitation dictated at the level of neurons. It is a locally stable equilibrium.

In fragile states this process of internalization has broken down. Many of the civil servants in these states are no longer sufficiently motivated by the public objectives of their work to put them before their own personal interests. Unfortunately, dysfunctional behaviour is also likely to be a locally stable equilibrium. New recruits, arriving with the enthusiasm and idealism normal in youth, adapt down to the prevailing norms. For example, Barr, Linderlow and Serneels (2008), find evidence for such a process even in the Ethiopian public health system (Ethiopia is evidently not a fragile state). Incremental reform is difficult because it faces a coordination problem: workers inevitably expect their co-workers to behave today much as they did yesterday, in which case it would be quixotic of them to change their own behaviour. Hence, within a reasonable horizon the existing system cannot be substantially improved. However, since overall provision is far below needs, as long as the finance for those needs is available an alternative approach is to supplement provision through a parallel public delivery system that is more functional. The existing system can be left in place, hence avoiding the political costs of challenging it. What might such a parallel system be like?

While the fragile states of Africa have retained a model of delivery of basic services which characterized the typical European states of the 1950s, meanwhile most European states have found this model increasingly deficient and have moved on. While there are many variants, the common element is to unbundle the functions that in the 1950s model are all performed by a single ministry. Some of these functions are intrinsic to the responsibilities that a state should undertake. For other functions the state can achieve its objectives better by purchasing the function from other providers. Even in the most centralized and efficient of European states this approach is now standard: for example, in France both blood-testing and ambulance services are financed publicly but provided privately. The model proposed here is a variant of this family of approaches.

An Auxiliary Public Service Agency (APSA) is a design of public service delivery which may be particularly appropriate for fragile state conditions. It need not be merely a temporary measure: it may evolve into a permanent organization much as Independent Revenue Authorities have become permanent in much of Africa. Although all APSAs have some core features in common, they can take many different forms. For example, at one extreme a single APSA could have a national mandate for many different types of service, while at the other each district might have several IPSAs, one for each type of service. Such choices should vary country-by-country, according to local capacity. Here I focus on the core principles of an APSA rather than on such choices.

An APSA is a public agency: it is an implementing agency of government but is independent of the civil service, analogous to central banks and revenue authorities. While it is an agency of government, its board of directors can include a minority of non-government appointees. These might include the main donor agencies and key components of civil society. The primary purpose of such representation is to provide equal and unrestricted access to information on the decisions and performance of the APSA for government, donors and civil society. As a result, an APSA is *structurally transparent*.

The government ministries responsible for service provision have representation on the board of the APSA and set policy guidelines by which the APSA must operate. For example, they may set minimum standards of provision, and require the APSA to allocate resources so as to ensure geographic equity. Ministries will also continue to provide state services directly. Since in post-conflict conditions service provision is invariably inadequate, the APSA should constitute an expansion in provision not a change in the management of existing services. Over time, if the APSA-provided services proved to be better value that those directly provided by the ministries then it would be a matter for the government to decide whether to reorganize the directly provided services: it might progress from being an auxiliary vehicle for service delivery to being the primary vehicle.

An APSA receives funds from donors and government for the purchase of services from primary providers. Since the APSA is an implementing agency of government, the money allocated to the APSA, including that from donors, appears in the government budget as an expenditure. Hence, donor funding of services through the APSA is somewhat analogous to ring-fenced budget support.

The APSA enters into contracts with primary service providing agencies but does not provide services directly. This avoids a conflict of interest and focuses the APSA exclusively on negotiating and monitoring the performance of the primary providers. These providers can be NGOs, local communities, local governments, or private for-profit organizations. Ideally, the APSA will experiment with multiple channels of provision for the same service to maximize the scope for variation in performance.

Unlike government provision, non-government provision is not a uniform model and there is considerable variation. Two different approaches can both achieve good organizational performance, which in turn is primarily dependent upon whether it is able to motivate its workforce. One approach, typified by mission-run hospitals and schools, achieves good performance by maintaining a high level of organizational commitment on the part of its workers. Given the high intrinsic satisfaction from activities such as healing the sick and teaching children, and the highly visible needs in post-conflict societies, it is possible to create islands of self-motivation even where in the public sector norms of service have collapsed. The other approach, typified by some for-profit organizations, achieves good performance by solving the difficult problem of linking financial incentives to observable performance. In many aspects of service

delivery individual performance is not readily observable and so effective monitoring is difficult. The two approaches are not easily combined and so tend to be alternatives. Norms of self-motivation, or working for the common good, thrive on trust and equity among staff. In contrast, the essence of addressing motivation by means of financial incentives is that trust is replaced by monitoring, and equity is replaced by income differences based on differential performance. Field evidence suggests that where strong financial incentives are introduced into service delivery organizations norms of service and worker cohesion are undermined.

According to the type of service, the local context, and the personal characteristics of managers, either approach can be more effective. However, while some non-government organizations solve the service delivery problem by one or other of the above approaches, others fail. Some rely upon trust but have unmotivated staff; others rely on financial incentives but monitor aspects of behaviour which are not sufficiently related to performance. Hence, the performance of the organization cannot be inferred from its design but must be observed. This is reflected in the IPSA, which devotes most of its resources to monitoring performance and comparing it. The evidence on comparative performance is provided to the board of the APSA on a regular basis. The board uses this information to reallocate resources from less-efficient providers to more-efficient providers.

The APSA can also experiment with distributing vouchers to households rather than money to service providers. This reduces the need for monitoring of performance but introduces other problems. To take a trivial example, in health care the prescription of glucose will produce a short-term improvement in the patient without addressing the causes of the illness. Users can easily misinterpret this effect as indicating that they need repeated treatment rather than different treatment. Hence, in the absence of good ethical standards among practitioners in this instance vouchers could be dysfunctional. More generally, the balance of whether service providers are more effectively monitored by professionals or by users will vary according to type of service and local context and is best determined by experiment.

An APSA has various advantages. It builds in variation in approaches to service delivery: different providers will be attempting to solve the problem worker motivation in different ways. Since the core function of the APSA is to evaluate these different approaches it enables gradual improvement in overall efficiency. The increase in efficiency comes about through two different mechanisms. The most obvious is through the awareness of competition acting as a disciplining device on providers. Through this mechanism, the performance of the typical service provider might be expected to improve. However, this is probably not the most important. The more important mechanism is that resources can gradually be reallocated from inefficient providers to efficient providers. Since the variation in efficiency between different providers is likely to be considerable, simply by reallocating money between them the IPSA can raise the efficiency of the average dollar spent on service provision. Note that this does not depend upon any improvement in efficiency in each organization.

Unlike the donor bypass of the state, with an APSA donor money is routed through a state organization. A condition of for a non-government service provider receiving money from the APSA should be that the services delivered are co-branded by government. While the visibility of donor operations is reduced, that of government is increased. Ordinary citizens are able to see that the government is doing something that is beneficial.

By design, the APSA generates information on the performance of the organizations that it funds, and hence on its own performance. Since donors are represented on the management board of the APSA they have full access to this information. Transparency of information for donors is crucial in post-conflict conditions to enable donors to scale up financing beyond the immediate post-conflict period. During the first few years donors give governments the benefit of the doubt, but this rapidly erodes. In its place governments need rapidly to build donor confidence. This cannot be done either by declarations or by comprehensive improvements in governance. Declarations of good practice can be made equally well by those governments that have no intention of adhering to them and so, despite a deceptively courteous reception, cut no ice with donors. Comprehensive improvements in governance simply take too long to achieve to stave of reductions in donor funding. An APSA provides a quick institutional solution to the problem of building credibility with donors: transparency and design substitute for the lack of trust. As quantitative evidence of performance builds up, the local offices of donor agencies are in a much stronger position to press their headquarters for a larger share of the budget.

The APSA retains the key benefit of central planning: resource allocation can be coordinated rather than being simply the aggregation of individual donor decisions. Further, since the APSA is designed to generate information, the precondition for central planning to be effective is met. However, while overall resource allocation is centrally determined, the incentive problem is not micro-managed. The APSA does not attempt to motivate or monitor the workers who deliver services. That task is decentralized to individual service providers to solve as best they can. The APSA faces the less daunting task of monitoring the overall performance of each delivery organization.

The Board of the APSA faces the task of motivating the staff of the APSA. Why might this be any easier than the task of motivating civil servants in the service delivery ministries or those in a Project Implementation Unit? In part it is easier than motivating civil servants because, being a new organization outside the civil service the APSA can start with higher pay structures that are credibly linked to rewards and penalties. Recruits have some reason to expect that the behaviour of their colleagues will not be the same as civil service behaviour. Perhaps more importantly, the remit of the APSA is more narrowly defined than the remit of a ministry. It is not trying to do everything from policy design to on-the-ground delivery of services. It is allocating money between providers and evaluating their performance. It is also subject to day-to-day scrutiny by donors and civil society who as members of the management board receive a continuous flow of information about the performance of managers. Motivation through internalization of objectives should be easier

than in a Project Implementation Unit because an APSA is permanent, and it has a national mission rather than being a temporary foreign entity.

An APSA does not need to start with a 'big bang'. It can start small, with one or two donors cooperating with a particular government ministry to finance an expansion in the delivery of a particular service. It should be viewed as an experiment in the architecture of public service delivery. As an experiment it should be evaluated, but, by design, such evaluation is automatic. If it succeeds it can be scaled up virtually without limit. Ultimately, the government might decide that the APSA, or a series of APSAs, is the most cost-effective and politically effective way of delivering services for the society. If it fails then it can readily be closed: donors are used to running projects which terminate. Nor is failure likely to have high costs. Unfortunately, there is currently no successful model of large scale service delivery in post-conflict conditions, so that the opportunity cost of failure is likely to be modest.

In summary, in fragile states governments have been attempting to deliver basic services using an inherited colonial model that has little prospect of success in the context of their own societies. Given the acute needs of their citizens, it is time for governments to experiment with other designs. The key desiderata are that a new system should be capable of being rapidly scaled up, while leading to something that is politically sustainable. An APSA is not as good as the 1950s European model when that model is deployed in ideal conditions. However, it is likely to be more successful than the centralized ministerial approach in the conditions that actually prevail in many societies.

Enhancing Public Investment: Sovereign Development Funds

One characteristic of all fragile states is inadequate public infrastructure: the legacy of decades of underinvestment. As part of the sustainable ascent from poverty these deficiencies will need to be rectified. The accumulation of adequate public infrastructure faces two hurdles. The most obvious hurdle is financial: money must be found and then ring-fenced for investment. But money alone is not enough. For example, the government of Nigeria (not a fragile state) has cumulatively spent some $16bn attempting to rectify shortages of electric power, yet without significant results. For money to produce results the process of public investment must be sound.

Most low-income states now have opportunities for financing a major increase in public investment. Partly this comes from donor money: although most aid budgets are under pressure, there is also a trend towards reallocating aid towards fragile states, exemplified by DFID, the World Bank and the European Commission. Further, within the aid budgets assigned to fragile states, there is a reaction to the previous donor fashion of prioritizing social spending, towards favouring infrastructure. However, aid-for-investment is fungible: governments can choose to reduce their own investment efforts. A clear indication of such behaviour is that by the 1990s in many fragile states the entire 'development budget' – that component of the budget that financed public investment – was aid-financed. Donors can reasonably expect that the governments of fragile states contribute some domestically-generated revenue towards the cost of new infrastructure but

for this to be a reality there has to be some corresponding political decision structure: a commitment technology.

In addition to donor funding, many low-income countries are now benefiting from substantial increases in revenues from natural resource extraction. Sometimes, as with the Chinese, this is directly linked to the provision of infrastructure, but more properly revenues can be used to augment public financing of infrastructure. There is an evident economic and ethical rationale for using a substantial proportion of the revenues from the depletion of public natural capital for the accumulation of other forms of public capital (Collier, 2010). Disturbingly, to date this has not been the global pattern because resource rents have been associated with political dysfunction (Ross, 2011). Controlling for the level of income and other salient characteristics resource rents have significantly and substantially reduced the public capital stock (Bhattacharyya and Collier, 2013). To neutralize political pressures to over-spend on consumption relative to investment governments need commitment technologies. Currently, the governments of several resource-rich countries are establishing such commitment technologies through variants on Sovereign Wealth Funds (SWF), examples being Nigeria and Ghana. These are constitutional devices which earmark a certain proportion of resource revenues for the Fund. In turn, money in the Fund can only be used for the accumulation of assets, whether foreign financial assets or domestic public investment. Since in a capital-scarce country it is unwarranted to accumulate long-term foreign investments, the core objective should evidently be to finance domestic infrastructure. Hence, to distinguish these vehicles from the conventional model of a SWF, in which the only permitted assets are foreign, it might be more appropriate to think of them as Sovereign Development Funds.

In principle, the political commitment technology of an SDF could be used for the donor finance of investment as well as for government revenues from natural resource depletion. Indeed, by making the two sources complementary through a matching-rule, donors can increase the incentives to resist the resource curse. However, the critical reason why donor finance should flow into SDFs is not macro but micro: donors have expertise in investment processes.

The process of public investment can be decomposed into four stages: project design, project appraisal and hence selection, implementation, and finally *ex post* evaluation. The quality of these processes has recently been assessed for ninety countries by the IMF and used to generate an index: the Public Investment Management Index (PIMI). Bhattacharyya and Collier (2013) find that controlling for the level of per capita income the PIMI is significantly worse in the presence of natural resource rents. Hence, reduced expenditure on the public capital stock is compounded by a poor investment process. Resource-rich fragile states need reinforcement of their processes of public investment just as they need reinforcement of their investment decisions.

If donors contribute financially to Sovereign Development Funds they can also contribute technically and politically. Technically, they can bring the standard international methods of project design, selection, implementation and evaluation. It is far better that these be integrated into a purpose-designed government agency than in free-standing *ad hoc* 'project implementation

units' which have been the customary donor approach. Further, as with APSAs, by creating a public agency outside the regular civil service with a narrowly-specified function, there is a better chance of achieving adequate standards than through the incremental reform of an entire civil service that is far below the necessary level. Politically, if the government wishes to reinforce its commitment technology, the donors can make adherence to these standard technical processes a condition of continued funding.

For many fragile states the challenge of using natural resource revenues is even more important for development than the use of aid. Were donors to offer to channel some aid through an SDF, it would encourage appropriate rules for investment to be established. Were donors to subject themselves to rules which maintained their support for an SDF over perhaps a decade, the formal rules which directly define the SDF might become internalized by its staff and the political elite, evolving into norms and habits which entrenched prudent decisions.

4.3 Strategies for assisting low-capacity governments: reinventing security systems

Insecurity as an economic trap

As demonstrated by the recent experience of Mali and the Central African Republic some African states continue to be fragile in respect of military security. More generally, the citizens of Africa's fragile states have usually already been the victims of organized violence and so perceive a continuing risk of becoming victims again. In effect, the governments of fragile states are unable to provide *credibly* effective security.

Such an inability commonly arises because the organization of non-government violence is relatively easy, while the provision of government force is relatively difficult. The organization of non-government violence is expensive and so to be feasible there must be a ready source of finance. Common sources are natural resources that can be looted; a foreign government that is hostile to the government of the country; and a lucrative criminal activity such as the cultivation or transhipment of drugs; and remittances from a disaffected diaspora. Conversely, governments may find it difficult to provide the minimum level of security necessary to ensure a monopoly of force within the sovereign territory. Since insecurity merely requires that security provision is occasionally punctured, the cost of rebellion is much lower than the cost of effective security. Hence, the same territory may have enough natural resources to support rebellion but not enough to support security. The resulting insecurity inhibits development by weakening property rights and so prevents the tax base growing to a level at which security would be affordable. The fragile state is trapped in insecurity.

The donor security dilemma

Insecurity is therefore a legitimate concern for donors. A corollary is that strengthening protection is potentially a legitimate use of donor resources. However, here donors face a dilemma. All states need some military capacity to repress, but the less inclusive is the government the greater the

repression that will be necessary to maintain order. A government that does not want to be inclusive but is stretched for resources may therefore accept a degree of inclusion in order to reduce insecurity. If a donor were to finance enhanced security such a government would choose to become less inclusive. Hence, donor support for security must be set within some larger political context that is capable of distinguishing between countries in which enhanced security would promote development and those in which it would make the state less inclusive. To date that has not been achieved. As a result, international support for Africa's fragile states has been insufficiently effective.

The Inadequacy of Current ad hoc international responses

Mali, the Central African Republic, DRC, South Sudan and Somalia have all received external military support, but in no case was the design of the support satisfactory. In Mali a democratic government with a weak army was threatened by an externally equipped Islamist extremist force but nothing was done until the last possible moment at which point the government invited military intervention by the former colonial power. In the Central African Republic a bilaterally arranged South African force was overwhelmed by a rebellion, resulting in the fall of the government and last-minute French military intervention to prevent a spiral into anarchic violence. In DRC a UN force proved ineffective in resisting a modest-sized rebel group. In Somalia an intervention by Ethiopia ended up provoking domestic opposition rather than securing the peace. Evidently, while the need for external military support is recognized, the organization of that support requires redesign. The Mali model of reliance upon a former colonial power was anachronistic; the CAR model of South African support was insufficiently powerful; the DRC model of a UN force lacked both a mandate and an incentive to fight; and the Somalia model of Ethiopian intervention ran too high a risk of a conflict of interest.

The Design of a Viable Model

Enhancing the security of fragile states can work through two complementary approaches: strengthening the provision of official security, and making rebellion more difficult.

An obvious model on which to draw for strengthening the provision of official security in fragile African states is NATO. At the time of its establishment in 1948, Western Europe included several fragile states which could not individually or even collectively provide adequate security. The NATO model was for a long-term structure of military cooperation without Western Europe underpinned financially and logistically by the USA. This proved to be enduring and effective. The role played by the USA vis-a-vis Europe in the period 1948-89 could potentially be played in Africa by the UN, Europe, the USA or NATO itself. A NATO-style security club, whether pan-African, sub-regional, or with an ad hoc membership, would have a standing force equipped for rapid deployment. African countries would provide the troops while external partners would provide the logistics. The command structure would need to be representative of its membership. It would need to evolve criteria for intervention and rules of engagement. The criteria for intervention would address the hazard of inadvertently weakening the incentive for governments to be inclusive: for example, they

could be conditional upon the government having been elected in an election judged 'free and fair'. The rules of engagement would address conflicts of interest – for example, neighbouring countries might be precluded from contributing more than a certain percentage of an intervention force. They would also address the risk of ineffectiveness – for example, they might have the duty to use force to protect civilians. So designed, a security force would be a boon to fragile states, enabling them to increase their security while reducing their own military expenditure. As such, it would be a reasonable candidate for donor financial support.

The counterpart to strengthening official security forces is to weaken rebel forces. The easiest point to target is money. Illicit revenues can be curtailed both by restricting illicit exports, as in the Kimberley Process, and by greater transparency in financial flows. The new emphasis in the 2013 G8 on bringing transparency to the beneficial ownership of companies has the potential to make all types of illicit transaction more difficult. The weakening of rebel forces in Eastern DRC during 2013 may be an instance of the growing effectiveness of financial pressure in curbing the capacity to fight.

4. Conclusion

The future of donors is in fragile states: that is where they have the potential to be strategically important. Unfortunately, donors have not yet evolved practices which are sufficiently distinctive to work well in such states. In this paper I have suggested a range of new approaches. Some, such as subsidized risk insurance and the investment in infrastructure, are designed to promote private investment despite the isolation inherent in fragility. Others, such as Independent Public Service Authorities, are designed to enable the public sector to perform its core role despite the dysfunction inherent in fragility.

By making aid in fragile states more effective, these approaches would also induce an increase in the volume of aid. Currently, donors face an unmanageable dilemma: a trade-off between providing aid to those countries most in need, namely fragile states, and providing it to those countries which aid is most reliably effective, namely those which face fewer problems. The Tinbergen Rule guides us out of this trade-off: new instruments are required which, though unnecessary in less challenging countries, enable aid to work well in fragile states. Once so equipped, donors can target aid volumes according to country need, while varying aid modalities according to the difficulty of achieving development.

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