

Growth and Equity in Fragile States

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Executive Summary

Fragile states are characterized by deep structural economic and political constraints. This study takes a long-term perspective on economic development in fragile countries to discuss structural causes of fragility. The guiding research question is how inclusive growth can be achieved in fragile states.

Dimensions of state fragility broadly cover aspects of security, economic and social development, as well as political representation and governance. The term 'fragility', however, hides a broad spectrum of heterogeneous country experiences ranging from countries in a situation of early recovery to countries with chronic levels of underdevelopment or protracted conflict.

The key insight of the economic growth theory is that high rates of accumulation of physical and human capital as well as technical progress may have a positive influence on growth. The critical question then is to explain why fragile states accumulate less capital than others and have lower rates of technological progress.

Modern theories of underdevelopment argue that severe distortions and inefficiencies in fragile state markets hinder the adoption of new technologies and a successful industrialisation process. Thus purely economic constraints may inhibit inclusive growth and could lead to self-reinforcing poverty traps.

Proponents of the geography hypothesis stress the direct effects of geographic conditions on the inputs of production functions or the production process itself. Possible constraints are climatic conditions, location, and natural resources.

The pace and structural features of economic growth result in distribution changes which mainly depend on country specificity. A middle range of inequality is supposed to be growth maximising and to vary across countries depending on structural determinants like natural resource endowments, the history of past policy decisions or asset distribution. While several transmission channels are argued for a negative effect of vertical income inequality on subsequent economic growth, the empirical evidence is ambiguous. Horizontal inequality, however, seems to be a risk factor for conflict and consequently low economic growth.

New institutional economics and political economy approaches explain poverty traps based on formal and informal institutional constraints. The basic economic rationale is here the importance of institutions to lower transaction costs to achieve economies of scale and specialization. The path of economic growth is determined by the quality of institutions. Low level equilibrium can persist over a long period of time. In addition, groups with political power may not be able to credibly commit on reforms.

An emerging consensus in the debate is that instigating growth may require only a 'small' set of reforms with limited institutional changes. An 'encompassing' authoritarian regime with 'good' economic policy may be pro-poor at the beginning of development in fragile states. To maintain productivity and to sustain development, however, economies have to initiate deeper levels of reforms and to acquire high-quality institutions. The central question for long-term inclusive growth in fragile countries would then be whether and how a society can transform its institutions at a deeper level to sustain long-term growth.

A final critical question is whether one also assumes that positive policy interventions would have an impact on inclusive growth in fragile countries. A policy hypothesis would argue that an adequate economic policy in the form of a stable macroeconomic framework can enhance welfare even when set against the background of detrimental geographical and institutional characteristics. **This paper argues that the policy, institutions, and geography hypotheses are interconnected as well as complementary and feasible policy recommendations very much depend on country analysis of the specific factors of underdevelopment.**

1. Introduction

This paper is the second part of a research project on economic development in post-conflict and fragile countries, a cooperation between the Clingendael Conflict Research Unit (CRU) and the Dutch Ministry of Foreign Affairs, in which CRU provides the Ministry with policy-oriented research on issues of security and development. The views expressed here are those of the author and do not necessarily reflect those of the Ministry.

The first part of the project researched the question of early recovery in post-conflict countries. Key questions were the relations and trade-offs between the strategic objectives of peace-building as well as security and development, the analytical integration of socio-economic development and conflict, the methodological conceptualization of a post-conflict 'transition' phase, the trade-offs between short-term and long-term development objectives, and the challenge of sequence and prioritization. The study proposed key elements of a 'consolidated' framework on 'early recovery and presented detailed policy recommendations in fourteen priority areas. To bridge the short-term and medium-term objectives, the report embedded the short-term stabilisation aspect in a medium-term development perspective.

Fragile states are characterized by deep structural economic and political constraints. **Thus the second part of the research project on economic development in fragile countries takes a long-term perspective to discuss structural causes of fragility. The underlying assumption is that the prevention of fragility requires a long-term endogenous structural transformation process. The guiding research question is how inclusive growth can be achieved in fragile states.**

The study is structured in three sections. In section I we briefly discuss concepts of fragility, possible features of 'fragile' countries and indices of measurement.

Section II analyzes endogenous reasons for fragility proposed in the theoretical literature. The aim of the chapter is to discuss the complex interplay between economic, institutional and political constraints of fragility. The section presents four strands of thinking on structural causes of fragility with a short critical review and policy recommendations for development given by these concepts.

Section III concludes with general prescriptions for pro-poor economic reform processes in the context of fragility.

2. Fragility

The purpose of this chapter is to give a brief overview of concepts of fragility, the present possible features of fragile countries, and to discuss problems with measurement indices.

Before we start with an in-depth analysis of potential structural causes of fragility, we have to clarify the scope and content of the term ‘fragile state’ and ‘fragility’. In general, the terms describe a heterogeneous group of countries with problems of governance, security, and development. Other labels applied are ‘failing’ states, ‘failed’ states, ‘collapsed’ states, or ‘crisis states’.¹ While the terms’ purpose is to capture real-world facts, the problem of stigmatising countries with negative labels has constantly been criticized (Stewart and Brown 2009).

The term ‘state failure’ is related to the discussion of the rent-seeking literature on the relative importance of government failures in contrast to market failures. Another point of departure is the failure of states to deliver minimal services of security and well-being with respect to a Weberian state concept (Di John 2008). Others explain the emergence and growing relevance of the fragility concept as “a political response to an operational issue”. The shift to budget support confronted donor agencies with a lack of political commitment in partner countries and subsequently with the problem of aid selectivity and aid orphans. In this context fragile countries are defined as having insufficient capacity to develop and implement pro-poor policies.²

Initially, the fragile states agenda focussed mainly on conflict and post-conflict countries, even if fragility is essentially a broader concept (Collier and Hoeffler 1998). Dimensions of state fragility broadly cover aspects of security, economic and social development, as well as political representation and governance. Stewart and Brown (2009), for example, propose a working definition with three basic dimensions of fragility:

Authority, service, legitimacy failures that occur, respectively, when the state fails to protect its citizens from violence, to provide services to all citizens and to be recognised as legitimate by citizens.

While authority failures also refer to a lack of protection from criminality, service failures capture development aspects like health, education and reduction in poverty income. Similarly the OECD Principles for Good International Engagement in Fragile States (2007) state the following:

¹ Here, we will not further delve into the fragile state discourse. See for a short introduction to the evolution of the discourse and the use of definitions Christoplos and Hilhorst (2009).

² See European Report on Development 2009.

States are fragile when state structures lack political will and/or capacity to provide the basic functions needed for poverty reduction, development and to safeguard the security and human rights of their populations.

The EU illustrates further aspects of fragility:

Fragility refers to weak or failing structures and to situations where the social contract is broken due to the state's incapacity or unwillingness to deal with its basic functions, meet its obligations and responsibilities regarding the rule of law, protection of human rights and fundamental freedoms, security and safety of its population, poverty reduction, service delivery, the transparent and equitable management of resources and access to power (EU 2007).³

While the notion of 'fragile country' and 'fragility' is still open to considerable discussions in terms of content, many existing definitions have been criticized for not capturing structural causes of fragility and not distinguishing appropriately between short-term shocks and long-term persistence in fragile states (Harttgen and Klasen 2009).

A related problem is the classification and measurement of 'fragility'. In reality there appears to be a broad spectrum of heterogeneous country experiences.⁴ The term 'fragile state' may hide the diversity of country experiences ranging from countries in a situation of early recovery to countries with chronic levels of underdevelopment or protracted conflict (Christoplos and Hilhorst 2009). Thus the rationale for classifying countries as 'fragile' and the generalization across very different situations and problems has been criticized.

Referring, for example, to the development aspect of fragility, recent research comes to the conclusion that the heterogeneity of MDG *performance* among fragile states is so vast that it is not very useful to treat fragile states as a group. In addition, little correlation has been found between fragility and *progress* in MDGs.⁵

Taking into account the difficulties in defining and measuring fragility as well as the considerable differences between agencies in listing countries as fragile, a certain degree of political reasoning may matter in the decision to label a state as 'fragile'.

The literature discusses several indicators to measure 'fragile' or 'failed' states, one of the most important being the persistence of political violence. While we will not discuss further the problems in operationalising the concept of fragile states, we finally present **two alternative indicators** in Box 1 below.⁶

³ The fragility concept is further discussed in the European consensus on development (2006) and the European Report on Development.

⁴ Taking into account the heterogeneity of fragile states' situation, the European Report on Development 2009 presents some common socio-economic features of fragile states in Sub-Saharan Africa: an inability to mobilise domestic resources and dependence on external resources, reliance on primary products, concentrated exports, low human development, and poor soft as well as hard infrastructure. See European Report on Development 2009. For a further discussion of socio-economic features of post-conflict countries, see also Maier R. (2010).

⁵ However, a strong negative correlation was found between fragility and MDG *levels*, see Harttgen and Klasen (2009).

⁶ Other approaches not covered here are e.g. the formal definitions of OECD-DAC, DFID and USAID.

*Box 1: Alternative indicators to measure fragility***Failed states Index (2009) - Fund for Peace:**

The FSI focuses on twelve indicators of risk and is based on thousands of articles and reports processed by the CAST Software from electronically available sources.

four social indicators (mounting demographic pressure, massive movement of refugees, legacy of group grievance, sustained human flight)

two economic indicators (uneven economic development along group lines, sharp and/or severe economic decline)

six political/military indicators (criminalization of the state, deterioration of public services, suspension or arbitrary application of the rule of law, security status operates as a 'state within a state', rise of factionalized elites, intervention of other states)

The methodology presents a framework for early warning and assessment of societies at risk of internal conflict and state collapse. The assessments include core state institutions needed to cope with the pressures upon states and are based on the identification of the presence and intensity of various measures and sub-indicators (e.g. inflation).

World Bank: CPIA – IRAI

The World Bank's definition of fragile states is based on a Country Policy and Institutional Assessment (CPIA, now referred to as IDA Resource Allocation Index or IRAI) rating of 3.2 or lower, as well as the presence of UN or regional peace-building or peace-mediation operations.

The CPIA rates countries against a set of 16 criteria grouped in four clusters:

- (a) economic management (macroeconomic management, fiscal policy, debt policy)
- (b) structural policies (trade, financial sector, business regulatory environment)
- (c) policies for social inclusion and equity (gender equality, equity of public resource use, building human resources, social protection and labour, environmental sustainability)
- (d) public sector management and institutions (property rights/rule-based governance, budgetary and financial management, revenue mobilization, quality of public administration, transparency/accountability/corruption)

The CPIA ratings are used in the IDA allocation process to evaluate the quality of policies and institutions as instruments to enhance aid effectiveness. The reasoning is that aid is expected to be more effective in a positive institutional and policy environment. However, CPIA rating has been constantly criticized for not adequately capturing the factors relevant to development.⁷

⁷ The CPIA has persistently been criticized for not including a security component. In addition, the rating process is seen to be not sufficiently robust and lacks internal consistency, the criteria do not adequately capture factors relevant to development and the rating and allocation decisions are assumed to be not sufficiently fair. For a current assessment of the strengths and weaknesses of the CPIA approach, see GTZ Discussion paper (2008).

3. Theoretical concepts and policy recommendations

Fragility by definition encompasses aspects of political violence and conflict, weak institutions and states, and low levels of economic and social development. This chapter aims to discuss the complex interplay between economic, institutional and political constraints of fragility.

3.1 Growth models and economic explanations for underdevelopment

While the discourse on ‘fragile states’ mainly starts from the state-building (and peace-building) perspective as a necessary prerequisite to development and transformation, we also include in the discussion **possible economic explanations for poverty traps**. One reason is that fragility is also defined by low levels of economic and social performance, which may result from constraints other than security or governance. A second reason is the importance of market failures in explaining chronic levels of underdevelopment.

The central result of the **traditional neoclassical growth theory** is long-term convergence to steady-state growth rates and per capita income for all countries with (costless and immediate) access to the same technologies. A permanent difference in income *levels* is only possible with different discount rates and tax systems. **The basic rationale of the Solow growth model with exogenous saving is that countries prosper due to factor accumulation and technical progress.**⁸ Inputs in the production function cover labour and physical. The steady-state growth rate of aggregate output depends on the rate of technical change as well as population growth. If two countries have the same rate of population growth, the same savings rate and access to the same production function, they converge to the same level of income. Consequently, higher saving rates or lower rates of population growth raise the long-term *level* of per capita income.⁹ Finally, the Solow model predicts that in countries with lower levels of capital-labour ratio like in post-war or fragile countries and further away from its own steady state value, per capita output should grow faster in the transition period to steady state (Solow 1956, Swan 1956).¹⁰ **Standard policy recommendations are confined to the advice to increase the saving rate and to implement structural adjustment**

⁸ In an economic model, an *exogenous change* is one that comes from outside the model and is unexplained by the model. Put another way, an exogenous change involves an alteration of a variable (e.g. saving) that is unaffected by the workings of the model.

⁹ The convergence to different steady states is called *conditional convergence* in contrast to *absolute convergence*.

¹⁰ The Ramsey growth model explicitly models the consumer behaviour of infinitely-lived households and endogenize saving (Ramsey 1928, Cass 1965, Koopmans 1965).

programmes (for instance, reducing inefficient tax systems and capital control mechanisms).

While the Solow model can explain some differences in income levels, it does a poor job in accounting for huge variations between countries.¹¹ Even if one assumes exogenous factor accumulation and fertility rates, the differences in saving and fertility are not large enough to explain the great differences in output.¹² Thus the production technologies must absorb most of the variation. Furthermore, in the long run, physical and human capital formation as well as the fertility rate are endogenous variables. **The central question would then be why societies stay at low levels of income (Azariadis and Stachurski 2005).**

The **new growth theory** is a reaction to the limitations of the neoclassical growth theory, which did not explain the mechanisms that generate steady-state growth. A major problem was the assumption of exogenous technical progress, which is endogenized in the new growth theory. The approach assumes a positive impact of capital accumulation on technical change. Positive spill-overs (or externalities) spread the new technology to other firms or countries, which result in constant or increasing rates of return. **If the use and production of technology is costly, fragile countries with low levels of resources and human capital are not able to afford or apply new technologies at the same productivity level.**

Two major strands can be distinguished. Models of 'innovation' see technical progress as planned and costly processes. The models concentrate on incentives which influence the process of innovation as institutions or size of market (Grossman and Helpman 1989, Romer 1990). Models of 'learning by doing' conceptualize technical progress as a non-intended by-product of goods production (Lucas 1988, Young 1991).

The new growth theory results in key insights for development in fragile countries. First, the models allow the reality of multiple equilibrium (in levels and growth rates) including the possibility of a self-fulfilling underdevelopment equilibrium. Second, development needs more than transfers of financial and physical capital. Third, capital can be drawn away from poor countries and foreign trade then helps primarily the richer countries. Fourth, technical progress is not easily transferred, but has to be – at least partly – domestically established.

Development policy should create conditions for 'learning by doing' and 'innovation'. One aspect is investment in the infrastructure of education and technological transfer which should include advice and technical assistance. A second aspect is the creation of necessary conditions for efficient investment in technological progress. The enlargement of markets through free trade zones, regional integration or the liberalisation of *advanced* countries' markets are possible options. Other possible policy alternatives cover industrial policy and infant-industry tariffs.

¹¹ Mankiw, Romer and Weil (1992) used an augmented Solow growth model incorporating human capital to account for the variation in standards of living between countries. They use the percentage of the working age population that are in secondary school as a proxy for the rate of human-capital accumulation. Empirical findings result in the conclusion that differences in saving, education, and population growth explain most of the international differences. Critics, however, point to the exogeneity of savings in explaining difference across nations (Easterly 2001).

¹² See, however, in this context the significant empirical results of 'conditional convergence' (Barro and Sala-i-Martin 2003). 'Conditional convergence' means that countries with similar institutions, policies and initial conditions may converge to a similar steady state.

Models of endogenous growth and the augmented Solow growth model predict a large effect of national policies on economic growth via changed tax rates (Easterly 2005). Empirical findings tend to confirm the relevance of *some* indicators of economic policy. The list of growth determinants cover, among other things, fiscal policy, inflation, black-market premiums on foreign exchange, financial repression or openness to trade (Levine and Renelt 1992, Barro and Sala-i-Martin 2003, Frankel and Romer 1999, Levine et al. 2000). **Easterly (2005)**, however, criticizes the fact that the large empirical effects of economic policies seem to depend on extreme observations in growth regressions and are not consistent with several stylized facts. **Furthermore, in fragile countries close to subsistence consumption, with a large informal sector and policy uncertainty, the theory would predict only a modest effect of domestic policy on economic growth. In the long run, institutions are supposed to outweigh the relevance of national policies for development.**

Similar criticism has been posed by **Rodrik (2007)**. His approach highlights the context specificity of growth-enhancing policies resulting from the limited generalizations we can draw on from empirical research on the policy effects of growth. **First, neoclassical economic analysis does not lead to unique policy packages, but allows for a broad area of possible policy activities adapted to the specific country context.¹³ Second, the approach distinguishes between igniting and sustaining growth. To start growth requires a potentially “small” set of reforms with limited institutional changes. To maintain productivity, however, economies have to initiate deeper-level reforms on the institutional infrastructure.¹⁴**

Modern theories of underdevelopment emphasize that severe distortions and inefficiencies in fragile economies can hinder the adoption of new technologies. A poverty trap can be defined as any self-reinforcing mechanism which causes poverty to persist.¹⁵ Many explanations emphasize complementarities between conditions necessary for successful development and the importance of coordination failures among economic agents.¹⁶

The **Big Push model** highlights the fact that production decisions by modern-sector firms may be mutually reinforcing. **The basic argument is that modern production technology is freely available to fragile states, but a small domestic market hinders adoption and does not justify the involved fixed costs.** If all sectors industrialize simultaneously, the size of the market may allow profitable investments. Since the coordination problem faced by monopolists cannot be resolved by the given market structure, the successful coordination of development would critically depend on institutions, political organization, and social as well as business conventions (Murphy, Shleifer and Vishny 1989). **A second example of strong complementarities is the O-ring model.** The model refers to the possibility that the value

¹³ Similarly, the World Bank (2005) report argues that general policy priorities need not be translated in a unique set of actions. In addition, different policies can yield the same result and the same policy can yield different results, depending on country institutional contexts and growth strategies.

¹⁴ The World Bank (2005) report highlights the importance of a process of social transformation for successful economic growth.

¹⁵ Azariadis and Stachurzki (2005) distinguish broadly between *historical* and *inertial* self-reinforcement. The first describes the effect of initial conditions of endogenous variables on long-term equilibrium. In contrast, *inertial* self-reinforcement can be determined purely by beliefs or subjective expectations.

¹⁶ Decisions of economic agents are called *strategic complements* if they mutually reinforce each other. *A coordination failure is a state of affairs in which agents' inability to coordinate their behavior (choices) leads to an outcome (equilibrium) that leaves all agents worse off than in an alternative situation that is also an equilibrium.* (Todaro and Smith 2009).

of increased human capital depends on similar upgrading by other agents (Kremer 1993). Finally, **restrained access to credit and insurance** due to market imperfections can result in low-risk strategies and low accumulation of human capital with low levels of development.

While poverty trap models are empirically difficult to measure, inefficient and small domestic markets describe significant features of fragile economies. Lopez/Servén (2009), for example, estimate a negative impact of poverty on growth which mainly works through decreased investment in countries with weak financial markets. **From a policy perspective, poverty trap approaches foresee the possibility to push the economy on a high level equilibrium with a temporary policy intervention. However, the size of the required intervention may be large and second-best policies may lead to significant distortions (Azariadis and Stachurzki 2005).**

Finally, we look at two major explanations of underdevelopment relevant to fragile states: civil war and natural resources.

Bodea and Elbadawi (2008) apply an endogenous growth model to analyze the impact of organized political violence on economic growth. In this framework, the overall effects of organized political violence are likely to be much higher than its destructive direct impact on capital. Using dynamic panel regressions, civil war and the risk of conflict were found to be negatively and highly significantly associated with growth. Finally, the authors argue that Sub-Saharan Africa is in a conflict-underdevelopment trap due to ethnic fractionalization. **Cerra and Saxena (2007)** find that civil wars and political instability lead to absolute divergence and lower long-term growth. The output costs of political crises are permanent on average and growth is significantly lower in the recovery phase than in an average expansion year. The findings cast doubt on the saving trap view which explains low development by an inability to save and invest. On the other side, **Chen et al. (2007)** argue that the end of war marks the beginning of recovery. While the authors compare the pre and post-war situation, the approach faces a selection bias by only taking into account cases of peace lasting 10 years.

Box 2: Natural resources and fragility

Homer-Dixon (1999) argues that resource scarcity and environmental degradation are critical to violent political conflicts.¹⁷ The basic argument is that land scarcity results in overuse and land degradation, which leads to social effects like poverty that may result in violent conflicts.¹⁸ Increased population density intensifies the problem. With reference to the new growth theory, the author highlights human ingenuity to solve the problem of resource scarcity. The creation of ideas is both technical and social, but poor countries face an ingenuity gap due to an incapability to deal with market failures and externalities, a shortage of capital or constraints on science. One problem with this explanation is that many conflicts occur in countries with an abundance of resources rather than scarcity. In addition, conflicts may be more dependent on growing inequality in access to land than on the low productivity of land use.

Resource-rich countries may face the problem of the resource curse. ‘Dutch disease’ effects may severely hamper the necessary diversification of the economy. Furthermore, natural resource dependence (on oil, diamonds, timber, gold and illegal narcotics) may have the potential to promote civil war by harming a country’s economic performance, by giving people in resource-rich regions an incentive to form an independent state, by being dependent on international price volatility and by financing rebellion (Collier and Hoeffler 2004, Fearon and Laitin 2003).¹⁹

However, the correlation between natural resource dependency and conflict risk may not be direct.²⁰ Failure in governance like systemic corruption or economic mismanagement are emphasized as mediating variables. Mismanagement of resource wealth and the inequitable sharing of natural resource revenues leading to horizontal inequalities are permissive factors for armed conflict. In addition, ‘unearned’ resource rents may allow elites to establish corrupt patrimonial networks and undermine state institutions or the establishment of a ‘social contract’.²¹

¹⁷ The author explains *environmental scarcity* as scarcity in renewable resources like cropland, forests, river water or fish stocks.

¹⁸ Homer-Dixon (1999) points to five social effects of environmental scarcity which may cause violent conflicts: constrained agricultural productivity, constrained economic productivity, migration, greater segmentation in society and the disruption of institutions.

¹⁹ Increases in world market prices for exported and imported primary commodities may have significant positive effects on the incidence of civil conflict (Besley and Persson 2009a).

²⁰ Four critical arguments are put forward in the literature. First, statistical results do not emerge in different datasets and methodologies. Second, the interpretation that resource abundance is a proxy for rebellion financing has been questioned. Resource abundance may also lead to conflict because of unfair wealth distribution. Third, the narrow measurement of natural resources (excluding diamonds and narcotics) has been criticized. Finally, reversed causality may bias the empirical findings, since the risk of conflict may increase natural resource dependence (Collier and Hoeffler 2004, Fearon and Laitin 2003, Humphreys 2005).

²¹ Di John (2008) distinguishes between two variants. First, in the tradition of *rent-seeking theories*, the abundance in resources may generate valuable rents and violent forms of rent-seeking. The question would be here why non-violent forms of rent-seeking are not sufficient. Second, in the perspective of *rentier state models*, large proportions of government revenue from external resource rents reduce the accountability of the government due to the decreased necessity of domestic taxation. ‘Unearned income’ could lead to a growing independence of states from citizens and a decline in bureaucratic capacity. The result may be weak state structures prone to violent insurgencies. The approach does not explain the process through which property rights over natural resources are

While there is considerable debate on whether abundant natural resources are directly linked to the onset of armed conflict, access to natural resources may have consequences for the character as well as the duration of conflicts and the efforts to end the war.²² Resource predation may only become relevant in the latter stages of a conflict and prolong the war. Furthermore, many conflicts have become systematically criminalized by combatants engaging in illegal economic activities via international criminal networks. Combatant remuneration in the form of exploitation of lucrative resources might lead to the fragmentation of rebel groups, thereby aggravating a peace agreement. Finally, companies in the extractive industries may become - willingly or unintentionally - intermediaries between local war economies and global commodity as well as financial markets (Malone and Nitzschke 2009).

The management of natural resources is critical and may cover a wide area of national, regional and international activities. Curtailing and managing resource flows through regional and international 'control regimes' has been proposed as one policy option. Measures encompass targeted commodity sanctions by the UN Security Council, the Kimberley Process Diamond Certification Regime as well as efforts to establish financial transparency by combating corruption and rent seeking by government elites in the extractive industries (Extractive Industry Transparency Initiative – EITI, Publish What You Pay campaign – PWYP) (Ballentine and Nitzschke). Other policy measures include the regulation of private sector activities in conflict zones ranging from voluntary codes of conduct to corporate regulation under national and international law (Malone and Nitzschke 2009).

3.2 Growth and inequality

A central ideal of modern societies is the equality of its members. Intuitively well accepted, important philosophical and economic questions follow: What exactly does equality mean when accepting human diversity? Equality of what: of rights, opportunities, or income? In addition, equality in one area may result in inequality in another area (Sen 1992).²³ Limiting the analysis here on income inequality: How much equality is feasible and what is the relation between inequality and economic growth? And, finally, does (income) inequality impact on social unrest?²⁴

Cornia (2004) answers the question of feasibility with an inverted u-shape curve on the impact of vertical inequality on growth. The concept distinguishes between a latent 'natural distribution of income rewards' based on the distribution of talent, effort and merit and the real distribution of income, which differs significantly due to market imperfections and differences in the distribution of endowments. Perfect equal societies suffer from incentive traps to work, problems of free riding, labour shirking, high supervision costs and corruption

assigned. In addition, the conditions under which predatory behaviour dominates development behaviour are not explained (Malone and Nitzschke 2009).

²² An additional framework proposed in the literature is the distinction between *lootable and unlootable resources* and their correlation with separatist as well as non-separatist conflicts (Ross 2003).

²³ Sen (1992). See for a discussion on measuring inequality, Cowell (2000).

²⁴ Even if we concentrate here on income-based measures, poverty and inequality are complex and multidimensional phenomena, which are measured by a multiple area of indicators (for example, health, education, gender equity, political participation).

in the redistribution system. On the other side, very unequal societies exhibit problems of incentive traps, erosion of social cohesion, social conflicts and uncertainty of property rights. Thus too much and too little inequality is growth impeding by reflecting only poorly the reward-based 'natural distribution'. **A middle range of inequality is supposed to be growth maximizing and to vary across countries depending on structural determinants like natural resource endowments, the history of past policy decisions or asset distribution.**

One aspect of the debate concerns the difference between an inequality and poverty focus. While the equality question takes into account everybody's income, poverty encompasses only the persons under a defined poverty line. Critics of an exclusive poverty focus point to the discontinuity of the policy with respect to the poor slightly beyond the poverty line and to a possible status quo aspect not threatening the richer part of society.

Box 3: Poverty Lines

Poverty lines are designed to compare poverty levels across time and space. An **absolute poverty line** is fixed in terms of living standards and fixed over the entire domain of poverty comparison. One example is the US \$ 1.25 a day poverty line (in 2005 prices) of the World Bank. A **relative poverty line**, by contrast, varies over the domain. It is measured, for example, as 50 percent of the median income. If, for example, the median income increases, the poverty line increases here as well (Ravallion 1994).

On a more fundamental level, the objective of pro-poor growth has to be defined. In general, one can distinguish between **absolute** and **relative inequality**. While absolute inequality is measured in differences, relative inequality is captured by ratios. An increase of income from \$ 1000 to 1100 for a poor person and from \$ 100,000 to 110,000 for a rich person would be equal in ratios or equiproportionate growth, but the rich person would gain a hundred times more than the poor person in absolute terms.²⁵

A related aspect is the **definition of pro-poor growth**. One definition focuses on the distribution effect defining pro-poor growth as a reduction of relative inequality. If the poor person would have gained \$ 1101 in the example above we would speak of pro-poor growth. The problem here is that the distributional change can be "pro-poor" with no absolute gain or even falling living standards for the poor. In addition, a "pro-rich" distributional shift may result in large absolute gains for the poor.²⁶ A second approach requires that growth is pro-poor if and only if it accompanies a reduction in an agreed measure of poverty. A proposed solution is to measure the pro-poor growth rate by the mean growth rate for the poor below an

²⁵ The design of an inequality measure in the income dimension is not an easy task. The main problem is the derivation of criteria which concretize ethical principles. There is no systematic approach to the criteria problem and standard axioms for inequality measures are not universally accepted. See Cowell (2000).

²⁶ To illustrate the first case, imagine that we have a positive distribution effect of 1 percent on the poorest 40 percent, but the mean growth rate is equal or lower than - 1 percent. There will be no or a negative effect on the poor. In the second case, we may imagine a mean growth rate of 5 percent, but a negative distribution effect of 1 percent for the poorest 40 percent. Even if we may have a 'pro-rich' distributional shift, the poor would nevertheless benefit in general from a 4 percent increase. See Kakwani and Pernia (2000).

absolute poverty line (Chen and Ravallion 2003).²⁷ The current **inclusive growth** concept of the World Bank applies the last objective (Ianchovina 2009).

Recent years have shown a plethora of studies on the two-way relationship between inequality and economic growth (Bourguignon 2003b). An early discussion of the **effect of economic growth on inequality** is the Kuznets hypothesis arguing that inequality increases temporarily when a country undergoes a transformation from an agrarian into an urban-based industrial economy. After a critical period average income inequality decreases (Kuznets 1955). Empirical research, however, rejects the Kuznets hypothesis and finds no effect of economic growth on distribution (Deininger and Squire 1998, Dollar and Kraay 2002).

Others deny a simple ‘trickle-down’ effect to the poor and argue that **a simple growth-enhancing policy is not enough**. Country comparisons show significant differences in the distribution effects of economic growth policies and aggregate distribution measures mask a wide variety of distribution changes between regions and groups within countries (Anderson and White 2001, Ravallion 2001, Christiaensen et al. 2002). **The basic result from cross-country regression analysis is that the pace and structural features of economic growth result in distribution changes which mainly depend on country specificity (Ravallion 2001). In this context, Bourguignon (2003b) highlights the importance of initial conditions and distributive-sensitive policy interventions.**

From the perspective of fragile states, also the effect of inequality on economic growth is important, since severe inequality can be a structural feature of political instability and social unrest. Three arguments have mainly been put forward in the theoretical literature for the negative effect of inequality on growth.

Galor and Zeira (1993) model the negative effect of income inequality on growth through **investment in human capital**. The approach assumes credit constraints due to imperfect capital markets which prevent poorer people from investing in education. In contrast, individuals with inherited wealth do not need to borrow money to invest in education. Finally, lower human capital will adversely affect economic growth in the model.²⁸ Thus the inherited distribution of wealth determines the aggregate level of investment, of skilled and unskilled labour and of output. Finally, the dynamics of the model emphasize that the initial wealth distribution determines the size of poor and rich dynasties as well as the type of the long-run equilibrium. While rich dynasties invest in human capital, engage in skilled work and leave a large bequest, poor dynasties inherit less, engage in unskilled work and leave less to their children. The authors conclude with the importance of having a large middle class for achieving economic growth.

Alesina and Rodrik (1994) model the negative impact of inequality on economic growth via **taxation**. The approach assumes unequal relative factor endowments in capital (physical and human capital as well as proprietary technology) and the *unskilled* labour of individuals. Government services are productive, benefit everyone and are financed by a tax on capital which stands for every redistributive policy transferring income to unskilled labour. Heterogeneity in factor endowments leads to a different ideal rate of taxation. Agents with income mainly from capital prefer a tax rate that maximizes the growth rate of the economy. The lower the share of capital income relative to the labour income of agents, the higher is

²⁷ For a more formal discussion see also Bourguignon (2003a). See also Eastwood and Lipton (2001).

²⁸ See also Aghion et al. 1999.

their ideal tax rate and the lower the growth rate. The tax rate selected by the government is the one preferred by the median voter or the majority of the population. Thus the higher the inequality in the capital income of the median voter, the higher is the rate of taxation and the lower is growth due to distribution struggles. If a large part of a population does not have access to productive resources, a society faces a strong demand for redistribution. Empirical findings confirm that inequality in income and land distribution is negatively associated with subsequent economic growth. One problem of the model is that the distribution of assets is predetermined and remains constant, while the economic growth process may affect income distribution.

Alesina and Perotti (1996) argue that income inequality increases **social dissatisfaction** creating incentives for individuals to engage in illegal and criminal economic activities. Social unrest increases the probability of coups, revolutions, or mass violence. Socio-political instability heightens policy uncertainty and threatens property rights which discourages investment and, as a consequence, reduces economic growth. **Empirical findings confirm that, first, more unequal societies are more politically unstable.** Political stability is improved by a wealthy middle class. And, second, political instability is negatively associated with investment and growth. **From a policy perspective governments would have to weigh the negative effect of increased taxation on investment with the positive effect of fiscal redistribution on social and political stability.**²⁹

Cross-country evidence on the effect of inequality on growth is ambiguous. Some studies find that higher inequality leads either to *increased growth* (Li and Zou 1998, Forbes 2001) or no growth effect (Barro 2000). Deininger and Squire (1998) find that *initial inequality in land assets* is associated with subsequent lower economic growth.³⁰ The authors do not find a significant relationship in democratic societies, but highlight the importance of imperfections in financial markets for credit and insurance as an explanation. Finally, Ravallion (2001) finds that initial - within country - inequality converges towards medium levels in accordance with the neoclassical growth model. While initial high inequality has the tendency to fall across countries, the process is not rapid but country-specific.

While most theories refer to the effect of vertical inequality on economic growth, recent research also points to the relevance of horizontal inequality. Horizontal inequality is a relatively new concept which has been proposed in the literature as a root cause of conflict. **Horizontal inequalities are inequalities in economic, social, or political dimensions or cultural status between culturally defined groups or groups with shared identities.**³¹ In contrast, vertical inequalities mean the differences between individuals in a society. While vertical inequality has not been found to heighten the risk of conflict, empirical

²⁹ For a summary of the theoretical discussion, see also Benabou (1996).

³⁰ Eastwood and Lipton (2001) argue that asset and income inequality are related. They propose that asset inequality is a proxy for *ascribed* inequality, capturing that part of income inequality that is hindering growth. The argument is that inherited land assets may harm growth by denying large parts of human resources the possibility of developing themselves and by hindering modern political systems supporting growth-enhancing property rights.

³¹ Group identities may arise partly from individuals' own perception or may be determined by the perceptions of those outside the group. Concepts concerning the formation of identities encompass the *primordialistic* view, which emphasizes the quasi-natural state of ethnicity. *Instrumentalists* focus on ethnicity as being developed instrumentally by groups or leaders to achieve economic or political goals. Finally, '*social constructivists*' emphasize the 'making' and 'remaking' of ethnic boundaries that make such instrumentalism possible. See Stewart (2008).

findings seem to support the relevance of horizontal inequalities for conflict.³² The basic rationale is that culturally-defined group identities in themselves are not a sufficient explanation for conflict, but need to match both economic and political causes to trigger conflict (Stewart 2008). Empirical findings in a recent research project highlight the relevance of higher socio-economic horizontal inequalities for a heightened risk of conflict. A central result is that conflict is more likely where significant political and economic horizontal inequalities run in the same direction (Stewart et al. 2008).

In the literature, four sources of horizontal inequality are highlighted. First, discrimination in taxation and the allocation of public spending may lead to horizontal inequalities. A second source may be the great inequality of land assets between opposing groups. Finally, economic mismanagement and recession as well as grievances related to natural resource rents are mentioned as sources of horizontal inequalities (Murshed and Tadjoeeddin 2008).

In general, policies to cover horizontal inequalities encompass a broad area. Direct horizontal inequality-reducing activities cover, among other things, quotas for employment or education as well as special investment or credit programmes for particular groups. Policies to reduce horizontal inequalities indirectly may include anti-discrimination legislation, general anti-poverty programmes, progressive as well as regional and district taxation, regional development programmes or sectoral support programmes. Public investment and government employment may be additional areas to address horizontal inequalities indirectly (Stewart et al. 2008).

3.3 Institutions, governance and the political economy

Neoclassical theory postulates that a particular set of institutions in an economy does not matter. The theory is based on the assumptions that (a) outcomes are determined by fundamental forces as resources, preferences and technology, (b) these forces lead to Pareto-efficient outcomes, and (c) institutions do not even impact on the choice of equilibrium. As a consequence, history does not matter (Hoff and Stiglitz 2001). In contrast, modern economic theory argues that institutions and institutional infrastructure are key components in sustaining economic development (Easterly 2005, Rodrik 2007).

The **New Institutional Economics** attempts to integrate a theory of institutions into economics. **North (1990)** defines institutions as [...] *the rules of the game in a society or [...] the human devised constraints that shape human interaction*. Institutions can be formal like judicial, political and economic rules, or informal, such as conventions or codes of behaviour. Institutions can critically determine the costs of transactions and production transformation by reducing uncertainty. **Coase (1937, 1960)** argues that transaction costs are only neglectable if one assumes that competition via efficient information feedback eliminates incomplete and asymmetric information. In this context, economic agents have to be rational. On the contrary, if one assumes that individuals act on incomplete information as well as bounded

³² Boix (2008) finds that political violence is associated with immobile and unequally distributed assets. Cramer (2003) criticizes the results of the cross-country regressions and suggests that economic inequality is important to explain civil conflict in a more indirect way. His main argument is the significance of varying *kinds* of inequality depending on historically established social relations and the ways societies manage inequalities.

rationality and informational feedback is insufficient, transactions are costly covering information and enforcement costs.

Institutions as an explanation for underdevelopment point to the **basic economic rationale between transaction costs and economies of scale and of specialization** (North 1981, 1990). In small rural communities transaction costs are low and production costs high, since specialization and a division of labour is hampered by the small size of the market defined by face-to-face exchange. To realize necessary economies of scale and to increase technology-induced productivity, the economy has to allow for impersonal exchange processes with high transaction costs due to the increased possibility of opportunistic behaviour. Thus institutional structures should be devised to constrain malfeasance.

Zinnes (2008) emphasizes that new institutional economics offers a common theoretical language to study behavioural forces which are prevalent in fragile states. The theory can give insights into the functions of a state, the existence of organizations and their evolution. Furthermore, new institutional economics can provide guidance in designing institutions and policies to **overcome collective action failure**. Examples are the design of credible commitment mechanisms for inter-temporal conflict resolution agreements among factions or designing mechanisms to compensate losers in political reform processes.³³

Williamson (2000) distinguishes four levels of social analysis with respect to institutions. The first level encompasses **informal constraints** and institutions like customs, traditions, norms or religion which change only very slowly.³⁴ The second level covers **formal rules** like constitutions, laws or the definition and enforcement of property rights. This institutional environment also includes executive, legislative, judicial, and bureaucratic functions of governments as well as the distribution of power across regions. A cumulative and significant change of formal rules is difficult, it may depend on some form of crisis and is assumed to occur only over decades. The third level analyzes the **governance of contractual relations** or the play of the game. While agency theory looks at the ex ante incentive alignment of governance structures to transaction types, transaction cost economics analyzes the ex post stage of contracts.³⁵ The final level comprises the elements of **neoclassical analysis** like resource allocation, prices, or technological innovation to get continuously marginal conditions right.

Possible positive functions of institutions encompass the following: to permit longer-term and lower-cost coordination and the use of credible commitment for reciprocal benefits, to protect property rights, to avert and resolve conflicts among individuals and groups as well as to constrain the powerful from abusing rules. In theory, well-designed institutions allow for specialization, risk sharing and intergenerational accumulation of knowledge. However, **institutions are not necessarily socially efficient**, since they may

³³ Zinnes (2008) correctly points to two limitations in applying the theoretical framework of the NIE to fragile states. First, economic incentives may not always be appropriate. In addition, the approach may be less helpful in changing human behaviour (preferences or norms) in the short term.

³⁴ North (1990) argues that informal constraints are important sources of continuity in long-term societal change. On the other side, one may also argue that informal constraints could hinder economic growth.

³⁵ New institutional economics assumes methodological individualism meaning that incentives are key for self-interested individuals. Transactions are limited by informational asymmetries and administrative costs to reduce them. Property rights analysis looks at the impact of assignment on economic outcomes. Research into incomplete contracts analyzes how post-contractual opportunism can be solved with credible or self-enforcing commitments.

be created to serve vested interests. Furthermore, **low level equilibrium can persist for a long time. Institutional path dependence may exist because of network externalities, economies of scope, and possible complementarities within an existing institutional matrix.** Put differently: individuals or firms with bargaining power in the political decision-making process may have incentives to perpetuate the existing institutional framework.³⁶

Several studies have empirically tested the impact of different aspects of **long-term institutions** on income differences.³⁷ **Acemoglu, Johnson and Robinson (2001)** estimate the effect of institutions on economic performance. They assume that Europeans adopted extractive institutions in colonies where settlement was impeded by high mortality rates and that early institutions persist and form the basis of current institutions. 'Extractive states' like the Belgian colonization of Congo did not protect property rights nor did they provide checks and balances against government expropriation. The main purpose was to exploit the natural resources. Using the death rate of soldiers, bishops and sailors as a variable for the mortality of early European settlers and an instrument variable for current institutions, the authors find a large negative impact of institutions on income per capita.³⁸

Engerman and Sokoloff (2002) highlight the importance of **initial factor endowments and the role of geography in shaping institutions** in Latin America. Geographical conditions and an abundant labour supply in the form of slaves favoured the specialisation in agricultural products like sugar. Substantial economies of scale in production led to the emergence of large slave plantations and the concentration of political power in a small elite. The high degree of inequality here explains the creation and path dependence of institutions in favour of the rich. Elites were better able to establish a legal framework that protected their interests and a share of political power, which in turn maintained high inequality. As a result, a society may not be realizing the full economic potential of disadvantaged groups.

Hall and Jones (1999) find that differences in **social infrastructure** can explain income differences across countries. Social infrastructure is defined as the institutions and government policies that provide incentives and determine the economic environment. Incentives can encourage productive activities or predatory behaviour such as corruption, theft or rent-seeking. The authors use an index of government anti-diversion policies (law and order, bureaucratic quality, corruption, the risk of expropriation, the government's repudiation of contracts) and openness to international trade as proxies for social infrastructure. Finally, social infrastructure is instrumented, since economies are not exogenously endowed with institutions. Countries subject to the strong influence of Western Europe, measured among

³⁶ North (1990) highlights self-enforcing mechanisms for the persistence of socially suboptimal institutions. An argument for path dependence is the idea of increasing returns in the adoption of particular institutions. Put differently: Adaptive expectations, coordination effects, and network externalities make it more attractive for others to conform. Thus a path chosen may 'lock in' the system for a long time in a low-level equilibrium.

³⁷ A large body of literature has researched the effect of economic institutions, see among others Knack and Keefer (1995) on property rights enforcement or Mauro (1995) on the effect of corruption on growth via investment.

³⁸ Engerman and Sokoloff (2002) criticize that areas with low mortality were often unattractive to European settlers. In addition, there may be reverse causality, with settler mortality being lower in areas with better institutions. Przeworski (2004) argues that the institutions have changed a great deal over time. Thus an instrument for initial institutions need not be a valid instrument for current ones. In addition, Bardhan (2005) is sceptical as to whether the approach captures major historical forces that affected the social and economic institutional structure of former colonies.

other things by the extent of Western European languages spoken, are found to possess a better social infrastructure.

Acemoglu and Robinson (2008) provide a simple explanation for the **persistence of existing institutions**. The authors define economic institutions as collective choices that are the outcome of political processes and depend on the nature of political institutions as well as the distribution of political power in society. The authors distinguish between **de facto and de jure political power**. Political institutions assign de jure political power and determine the constraints on and the incentives for key actors. In contrast, a group of well endowed individuals may possess de facto political power. Two mechanisms explain **resistance to economic reform**. First, agents with de jure political power have incentives to maintain existing political institutions. Second, an unequal distribution of resources assigns de facto political power to elites which may use their power to reproduce economic and political institutions in favour of initial disparity.

The authors argue that groups with conflicting interests may not agree on a set of welfare-maximizing economic institutions, since **groups with political power may not be able to credibly commit to reforms and economic as well as political institutions may be mutually self-enforcing**.³⁹ In addition, groups may use existing de facto political power to change political institutions in their favour to secure benefits in the future, since de facto political power may be only transient. Finally, the authors highlight that a successful change of economic institutions critically depends on an understanding of political forces in the form of political institutions and the distribution of political power.⁴⁰ **North (1990) emphasizes two additional aspects with relevance to fragile states**. First, informal institutions are important for economic performance, but change only very slowly. Second, transferring successful formal rules from one context to another may not necessarily lead to good performance due to a different setting of informal constraints.

While positive institutional change is critical and may be very slow, recent research is relatively ambiguous as to **what are the relevant institutions to reform**. One part of the debate discusses the **relevance of the political system for development**.⁴¹ Empirical research has tested whether **democratic or authoritarian governments** are better for growth. **Barro (1994)** suggests an inversed u-shaped relationship between democracy and growth. **Persson (2005)** denies the relevance of a simple distinction between democratic and non-democratic forms of government. Applying cross-country and panel data research, the author finds that

³⁹ In addition, Bardhan (2005) emphasizes the enormity of the *collective action problem* for institutional change in a society. The author distinguishes between the *free-rider problem* on sharing the costs of change between the groups and the *bargaining problem* to settle an agreement. Referring to the analysis of collective action by Olson (1965), the costs of collective action may be too high when there are winners and losers from a productivity-enhancing institutional change. Losses of the potential losers may be concentrated and transparent for the rich, while the gains of the potential winners (the poor) may be diffuse.

⁴⁰ The authors sketch a relatively pessimistic picture of institutional change. Directly reforming one specific economic institution without altering the existing political equilibrium may simply lead to replacement. Reforming political institutions may not work due to de facto political power. In addition, changes in both de jure and de facto power may not be successful due to path dependence. Existing institutions could give new elites the incentives to behave the same way (Acemoglu and Robinson 2008).

⁴¹ Bardhan (2005) highlights that the regime of political rights is relevant for explaining differences in human development indicators. Furthermore, the author argues that particular social and political institutions are crucial for economic performance, but the effect is only difficult to quantify. In this context, a comparative-historical analysis of societies' imperfect coordination mechanisms is suggested.

reforms in parliamentary (as opposed to presidential), proportional (as opposed to majoritarian) and permanent (as opposed to temporary) democracy are associated with the adoption of structural policies promoting long-term economic growth. In contrast, **Keefer (2004)** argues in his review of the empirical literature that electoral and political institutions affect policies, but are not crucial determinants to explain economic performance.⁴²

The literature offers several mechanisms to explain the relevance of democracy for economic performance: the importance of democratic participation in a generalized interpretation of the “rule of law”, the relevance of participatory democracy in facilitating the use of local knowledge for the process of successful institution-building, or the importance of an active electorate as an incentive for governments to respond to economic problems (Bardhan 2005, Rodrik 2000, Besley and Burgess 2002). **While the transition from authoritarian to democratic regimes may improve economic performance, authoritarian regimes may also be relevant at the beginning of development in fragile states** (Rodrik and Wacziarg 2004). **Glaeser et al. (2004)** argue that poor countries develop mainly through good policies in the form of human capital accumulation often implemented by dictators. While criticizing the conceptual appropriateness of indicators of institutional quality, the authors find that political institutions improve only gradually as a consequence of economic development. Dictators may be able to implement good economic policy, if their commitment is credible.⁴³

Olson (1993) deals with the relevance of dictatorship for development in two directions. First, the author distinguishes between ‘**roving**’ and ‘**stationary bandits**’. Denying the possibility of a peaceful order by an agreement between a large group of individuals due to the collective action problem, the author assumes a state of anarchy and uncoordinated competition under ‘roving bandits’. This environment offers little or no incentive to produce or invest and little for bandits to steal. Thus rational bandits face an incentive to be ‘stationary’, rule a given domain, and provide peaceful order which increases the incentive to produce and obtain more tax theft than from migratory plunder. The ‘encompassing interest’ of autocrats increases with the size of the stake in society. However, autocrats have the incentive to charge a maximum monopoly rent not only for public goods, but also for their own purpose in the form of a sub-optimal revenue-maximizing tax rate.

Second, the theory states that autocratic regimes may result in temporary economic performance, but only democracies can sustain and maximize permanent development. Autocrats cannot credibly guarantee private property and indefinitely impartial contract enforcement which is necessary for long-term investments, since dictators may have a short-term view and their promise cannot be independently enforced. Succession crises increase uncertainty and incentives for short-term investments. Finally, the author denies a simple transition from autocracies to democracies due to a collective action problem. Democracies may emerge spontaneously when successive individual or group leaders cannot establish another autocracy. The central question would then be **how a fragile country under a dictatorship transforms its institutions at a deeper level to sustain long-term growth** (Dixit 2006).

⁴² Bardhan (2005) criticizes the methodological problems of cross-country regressions like endogeneity, selection bias and omitted variables. In addition, the econometric approach does not explain the mechanisms through which democracy may prevent or promote economic development.

⁴³ On a discussion of the concept of credibility and its relevance for development, see also Bardhan (2005).

Acemoglu and Robinson (2001) offer a simple theory of political transition. The authors start from the recognition that many Latin American countries oscillate between democracy and non-democratic structures. Non-democratic societies are assumed to be controlled by a rich elite. The poor are excluded from political power, but pose a revolutionary threat when the opportunity cost is low, such as during an economic recession. The rich may offer some form of redistribution and democratization to prevent revolution. Since democracy may be too redistributive, the rich may also have an incentive to mount a coup. Thus **inequality** is a critical determinant for political instability. In essence, the theory explains unsuccessful political transformation by the **problem of credible commitment**. Both the poor and the rich may not be able to signal to their counterpart a credible commitment to a permanent compromise.

A second part of the debate looks at the **role of government for development as well as government failures**. **Public choice theory**, part of the **new political economy**, argues that governments are not efficient, purely altruistic entities that effortlessly correct market imperfections. The basic rationale is that politicians and bureaucrats act solely from a self-interested perspective creating wasteful lobbying efforts known as rent-seeking. In its purest form, the theory postulates that the state should be minimal and retreat from interventions in the economy (Buchanan 1954).

Rent-seeking occurs when agents seek to earn income by economic rents without making any contribution towards productivity (Tullock 1967). *Rent-seeking is the expenditure of resources and effort in creating, maintaining and transferring rents* (Khan and Jomo 2000). Competitive rent-seeking leads to welfare losses and divergence between private and social costs. Rent-seeking activities encompass a wide spectrum of market-distorting activities in the form of specific monopoly privileges like government regulations, market entry barriers, import licences or control over pre-existing natural resources. Illegal rent-seeking may encompass bribery, corruption, smuggling, or black markets (Krueger 1974).

Bardhan (1997) applies the use of public office for private gain as a definition of corruption.⁴⁴ The author uses the agency theory as an analytical framework to look at corruption meaning that the public (principal) has difficulties in monitoring the government or official (agent). The literature discusses several positive effects of corruption on economic development. First, corruption may be welfare improving in a second-best environment with pre-existing policy-induced distortions. Second, corruption may be seen as 'speed money' to reduce delays in rigid administrative processes. Third, corruption has been historically associated with the emergence of an entrepreneurial class. Bribing may have been a collective mechanism to prevent conflicts (Bardhan 1997).

On the other side, corruption may have negative effects on both efficiency and growth. **Shleifer and Vishny (1993)** argue that corruption is especially costly for economic development in **countries with weak governments**. The weakness of central governments allows competing governmental agencies and bureaucracies to impose independent bribes on private agents seeking complementary government goods to conduct business. The basic assumptions are that government agencies can act as independent monopolists and have the

⁴⁴ For an overview of contemporary policy-oriented corruption research for foreign policies towards developing countries, see Andvig et al. (2000).

power to halt projects. **Thus a less restricted entry of government agencies into regulation may strongly increase the burden of bribe-preventing necessary investments to foster growth. The analysis can explain why strong centralized governments may exhibit lower corruption rates than fragmented governments.**

The authors also highlight that the efforts to avoid detection and punishment can cause even modest corruption to be much more distortionary than taxation. Corrupt officials may try to induce investments in the direction of lower-detection activities like imports of inappropriate high-level technology or large defence contracts. The necessity of secrecy may also hinder change by excluding innovative outsiders from both economic and political participation. Corruption can also have a disincentive effect on investment by the declining profitability of productive investment and divert growth-enhancing resources to private consumption.

Mauro (1995) empirically estimated the effect of bureaucratic efficiency on economic growth in a cross section of countries. Using an average of subjective indices on the efficiency of a judicial system, corruption and red tape, bureaucratic efficiency is found to be negatively associated with investment and economic growth. **Svensson (2005)** re-ran the regressions with updated data. The author finds that corruption is only insignificantly negatively associated with economic growth.⁴⁵ Economic growth may also have an effect on the extent of corruption. **Bardhan (2005)** hypothesizes an inverse u-shape of the relationship between corruption and economic growth. Corruption may increase at certain points during phases of economic development. Thin markets for new products or dual-track economies with both controlled and market prices may be special factors of transition economies creating new opportunities for corruption. In general, corruption in more advanced countries is found to be lower which may be explained by better payment of civil servants and better institutions.

Recent economic theory explains the difference between countries and the persistence in corruption by frequency-dependent equilibrium. Countries remain in a high corrupt equilibrium if the proportion of dishonest officials has passed a certain threshold. The more officials who are corrupt, the less is the loss of reputation, the risk of being detected or the search cost in finding a briber. The model would predict a low-corruption equilibrium in case of a low proportion of dishonest officials emphasizing the importance of initial conditions. Finally, the mutual benefit between public officials and bribers may provide no side-incentives to change their behaviour (Bardhan 2005).

Khan and Jomo (2000) opt for an extended rent-seeking framework incorporating political and institutional determinants to explain the input and 'rent-outcomes' of rent-seeking. The central arguments are that rent-seeking is closely related to processes of institutional change and that attempts to change the structure of rents can trigger distributive conflicts. The net effect of a rent-seeking process is determined as the subtraction of rent-seeking costs from net social benefit associated with the rent outcome. While the former are the costs of activities to create, maintain or reallocate rents like the inputs into lobbying, bribing or political activity, the latter encompass the net social costs or benefits associated with the rents which may vary between different types of rents.

⁴⁵ For more empirical findings on the microeconomic level, see for example Svensson (2005), Andvig et al. (2000).

The central idea is that rent outcomes may also have a positive social value for the society and that rent-seeking is a process through which the structure of economic rights may change.⁴⁶ As a consequence, countries may grow if the net effect of rent-seeking activities is positive and the rent-seeking system allows a developmental effect. In contrast, poor economies are seen as being unable to create and maintain socially valuable rents. The authors conclude that the critical problem is to transform economies to rent-seeking systems being developmental.

Related to the distinction between growth-enhancing and impeding rent-seeking systems, **Khan (2007)** further distinguishes between **market-enhancing and growth-enhancing governance**. The former is seen as a conventional approach by 'good governance' proponents. Market-enhancing governance is supposed to concentrate on the reduction of transaction costs to foster efficient markets. Key policy goals are stable property rights, a good rule of law and effective contract enforcement, low expropriation risk and corruption, and an accountable provision of public goods.

In contrast, the author opts for a growth-enhancing governance perspective. The basic rationale is that markets in developing countries are inherently inefficient and face significant transaction costs which may only change with a higher level of development. Key governance goals are the management of incentives to achieve rapid technology acquisition, political stability in a context of social transformation and asset reallocation to the most productive sectors.

Khan (2007) highlights that 'good governance' conditions are extremely difficult to implement in poor or fragile countries. Furthermore, even efficient markets may face market failures in organizing a learning process to increase productivity. States need the capacity to accumulate capital and learn new technologies quickly which could include a governance framework that increases rent-seeking opportunities.

Heterodox institutional economists correctly point to the empirical evidence that successful (Asian) emerging countries have grown within a governance framework which is quite different from the 'good governance' model. On the other hand, even Khan (2007) admits that [...] *in most developing countries where strategies of growth-enhancement were attempted, the results were poor*. The author argues that states need appropriate *governance capabilities* like complusion and discipline to overcome the moral hazard problems and implement successful development strategies. The question remains whether these capabilities are not close to the requirements of the new institutional economics.⁴⁷

Sociology, political science and international relations literature often criticize the neo-utilitarian basis of new institutional economics as well as the new political

⁴⁶ The authors explain differences in rent outcomes across countries by differences in institutional structures, the political power of competing groups and their ability to resist change (Khan and Jomo 2000).

⁴⁷ Rodrik (2008a, 2008b) argues that large-scale institutional transformation is in general not a prerequisite for igniting growth. Furthermore, the author highlights the relevance of second-best institutions. With a similar perspective, Grindle (2005) emphasizes a 'good enough' governance approach. The concept suggests that not all governance deficits need to be (or can be) tackled at once and that institution and capacity-building are products of time.

economy and discuss the problem of fragile states.⁴⁸ ‘Predatory’ or ‘developmental’ states are common terms within these strands of thinking.

In his response to the minimal role of governments assigned by the public choice literature, **Evans (1989)** suggests a more differentiated analysis of the role of states in developing countries. ‘Predatory’ states impede economic transformation by plundering resources without investment in public goods. ‘Developmental’ states promote growth by increasing incentives for entrepreneurial perspectives among private elites. Rent-seeking activities may be part of the process, but do not hinder sustained development.

Taking a comparative historical approach, the author emphasizes the importance of a determined and effective state apparatus. With reference to Weber, a state’s capacity to support markets critically hinges on a bureaucracy being a corporately coherent entity. Bureaucratic efficiency is enhanced by meritocratic recruitment and some insulation from the demands of society. Referring to a Hirschman and Gershenkron approach, entrepreneurship however needs a state which also induces private capitalists to make risky investments. In the author’s view of **‘embedded autonomy’**, a state requires active agency and sophisticated responsiveness to transform economies. **Thus a developmental state is assumed to depend on a meritocratic bureaucracy with a strong sense of corporate identity and a dense set of institutionalized links to private elites.**⁴⁹ One conclusion is that the **construction of bureaucratic capacity is a crucial development task.**⁵⁰

Box 4: Functionalist theories of states

Functionalist theories of the state question the concept of ‘state failure’. Identifying or measuring state failure is assumed to be misleading, since **clientelist and patrimonial states are purposefully constructed by elites to stay in power and foster their interests**. A variation of models seek to explain how states without developmental goals have emerged and what the political dynamics are which hold these societies together.

Functionalist theories often base their explanations on an analysis of historical constraints in the post-colonial environment. The legacy of colonialism in Africa, like a despotic system, a predominance of tribal leaders, duality between urban and rural areas as well as the rapid decolonisation, favoured clientelism and neo-patrimonialism. Political leaders are assumed to adapt by informal mechanisms of control such as relying on existing political structures and forging political alliances by patronage.

Chabal and Daloz (1999) propose that the colonial legacy of feebly institutionalized bureaucracies created incentives for political leaders to use **‘disorder as a political instrument’**.

⁴⁸ The term ‘political economy’ is used in varied forms across disciplines. For a discussion on the theoretical framework of the ‘new political economy’, see Besley (2004).

⁴⁹ Evans (1989) correctly hints at the fact that developmental states need not persist nor satisfy future social needs due to less dependence on private capital from the state.

⁵⁰ Mkandawire (2001) criticizes, at length, the impossibility theses of developmental states in Africa. Furthermore, Besley and Persson (2009) discuss the importance of state capacity for development in an economic approach and the relevance of past conflict for fiscal and legal capacity-building. Finally, the authors correctly state that both a benevolent and malevolent view of government is rather stylized.

The second argument relates to deeply-rooted cultural particularities like kinship, witchcraft or different religious forms which might be hostile to the construction of a state or effective administration. Personalised informal patron-client networks find ways to translate social disorder into patronage resources. As a consequence, the failure to build institutionally distinct and effective states may make development impossible. Economic liberalisation is supposed to increase opportunities for the 'shadowy entrepreneurial elites'. Finally, the authors argue that development in the Western sense is not *the* priority of a majority of Africans, but that the countries would head towards modernity without development.⁵¹

Keen (1998) argues that war and violence serve important functions in the contest for power and capital accumulation. The conduct of war becomes instrumental to the accumulation of economic assets, and economic benefits arising from wars may be relevant for the duration and persistence of conflict. Economic opportunities may encompass pillaging, protection money, monopolising trade, labour exploitation, stealing aid supplies or benefits for the military. Keen (2008) distinguishes between three economic activities in a war economy. The majority of activities are impeded by war like agricultural production or tourism. Some activities are consistent with the war such as, for example, offshore oil exploitation. For a very small elite, some economic activities are more profitable in conditions of conflict.⁵² Thus elites may have no incentive to end profit and violence may be used as a means to an economic end.

In addition, direct economic gains may explain the ruthless activities of warlords during conflict. In turn, predatory aims of political and business leaders in the form of 'top-down' economic violence can fuel a civil conflict and undermine long-term development.

Reno (2000) argues that shadow states reflect systemic and deliberate corruption as an integral part of political control. The author defines a shadow state as a form of personal rule constructed behind the façade of laws and government institutions. The shadow state is based on the abilities of its rulers to increase power by controlling external actors' access to markets. Similar to the idea of de facto political power, rulers may undermine formal institutions of government and reproduce economic and political institutions in their favour (Acemoglu and Robinson 2008). The reason for this is that leaders may fear formal institutions questioning their power. As a consequence, incompetent administration and development impeding policy can be a deliberate goal to strengthen political authority.

⁵¹ Related to the discussion on the negative effect of economic liberalization and globalization, Kaldor (1999) outlines her thesis of 'new wars'. The author argues that '*new wars*' are a new type of organized violence which has to be understood in the context of political, economic, military and cultural globalisation. While '*old wars*' are fought between states, '*new wars*' describe international or civil wars involving a plethora of transnational connections. Neo-liberal policies are supposed to have led to an environment of criminalization due to increased deregulation. A politics of identity in the form of ethnic or religious movements arise out of the weakened state structures. The war economy is built on plundering, black market transactions as well as external assistance and diaspora financing, since production has collapsed due to liberalisation. For a further discussion of the idea of new wars and the effect of globalisation, see also Duffield (2001).

⁵² Goodhand (2004) distinguishes between a *combat economy* which includes the production, mobilization and allocation of economic resources to sustain a conflict and economic strategies of war to destroy the resources of opposing groups. A *shadow economy* means the existence of significant economic activities outside the legal framework. Key actors may be 'conflict profiteers' like entrepreneurial elites and those engaging in organized crime who tend to profit from corruption and weak institutional arrangements. *Coping economies* encompass economic activities by the civilian population to cope and survive in a (post-) conflict economy. Another possible categorization would be between a formal, informal, and criminal economy. Criminal economic activities encompass a broad range of criminal and para-criminal activities (Kamphuis 2005).

The author highlights that shadow state rulers may also instrumentalize the youth to intimidate opponents in the contest for economic and political power. Economic reform processes from outside may increase the incentive for rulers to exploit resources and destroy remaining bureaucracies.

Di John (2008) lists four important shortcomings of functionalist theories:

First, the **idea that neo-patrimonial politics is necessary anti-developmental is ahistorical**. Rent-seeking behaviour is a general feature of all developing countries in a structural transformation process. In general, the enhancement of institutions requires a significant level of development. The key analytical challenge is then to explain why some countries are able to create more developmental outcomes in the context of clientelism, predatory behaviour and corruption (Khan and Jomo 2000). In addition, many Sub-Saharan countries achieved significant growth rates in the period 1960 to 1980 and the first seven years of the 21st century (Mkandawire 2001).

Second, **the suggestion that economic liberalisation weakened states further or was a cause of violence in all African states is not supported by empirical evidence**.

Third, **in many civil wars leaders were not able to use informal patronage to stay in power**.

Finally, **the idea that there is only one type of African politics is at odds with reality**.

3.4 State-building

The literature on state-building puts the establishment of a stable state at the centre and is largely driven by international relations and political science. The **OECD (2008)** asserts that state-building is the central objective of international engagement in fragile states. In this framework fragility stems from a weakness in the dynamic of a political process through which citizens' expectations of the state and state expectations are normally brought into equilibrium. A disequilibrium in the negotiation over a social contract can arise as a result of incapacity, elite behaviour, or crises of legitimacy. Since resilient states exhibit effective political mechanisms to manage shocks and pressures, the overarching priority of state-building should be a focus on governance structures that address inequalities and promote accountability. State-building as a gradual process of institutionalisation is supposed to be equally or more important than a poverty reduction goal.

Scott (2007) correctly highlights that the development community has not widely published on state-building and is hesitant to adopt the terminology. **One reason might be that development policy is mainly concerned with poverty reduction and the needs of the poor, while the state-building literature discusses more the role of external actors from the international community**. Another aspect of the debate is the distinction between 'state-building' and 'nation-building'. While sometimes used interchangeably, **'state-building' is often defined as an interventionist strategy to restore and rebuild the institutions and apparatus of the state**. On the other hand, 'nation-building' may also encompass the creation of a cultural identity (Scott 2007).

One strand of the literature discusses the **relevance of war for the establishment of an efficient state apparatus**. Tilly (1985) argues that ‘war made the state and the state made war’. The formation of European states in the 16th century seems to underline the critical contribution of external threats and war. The basic rationale is that conflicts forced states to be more efficient in revenue mobilization for military expenditures. Thus administrative capabilities had to be dramatically improved. Within this framework, the distribution struggle between the state and social actors to finance war led to the establishment of mutually recognized rights: rights of citizens with respect to states as well as rights of state officials with respect to citizens.⁵³ As a consequence, political violence may play a critical role in the establishment of state structures and development.

Several counterarguments stand out on the relevance of the historical state-building process in Europe for fragile states today. On a general level, the transferability of historical lessons to contemporary problems can be questioned. The social and historical contexts of developing countries today may be markedly different to the situation of pre-modern European countries. The current global political climate with globalization and a massive aid infrastructure is radically different to previous centuries. Poor economies today face greater forces of decentralisation and the privatisation of coercion and capital. Due to the increased relevance of external financial relations like external debt, governments are far more sensitive to the preferred policies of international actors (Scott 2007). Furthermore, **Herbst (2000)** argues that the central problem of state-building in Africa was to project authority over inhospitable territories in areas with a low density of population. The contradiction of states with incomplete control over hinterlands but full claims to sovereignty is assumed to be crucial to understanding the state failure in Africa, since there was little incentive to build domestic taxation systems and effective administrations to finance the defence of boundaries.⁵⁴

North, Weingast and Wallis (2009) challenge the prerequisite view of state-building for development. The authors argue that violence is widespread among society and that state monopoly on violence has to be explained rather than assumed. Starting from a natural state close to a Hobbesian world, most societies are assumed to have solved the problem of endemic violence in the form of **limited access orders**. A dominant coalition creates opportunities and order by limiting the access of valuable resources or valuable activities to elites to generate rents. Insiders have incentives to cooperate with the coalition in power to sustain access to rents. The basic rationale here is that a limited access order creates an incentive for a credible commitment among elites. In contrast, **open-access order societies** are defined to be Weberian in nature: the government holds a monopoly on the legitimate use of violence. In turn, the government is controlled by clear and well-understood rules. The basic idea here is that open access to the political, judicial, social and economic system is mutually reinforcing.

The authors explain a possible transition from limited to open access orders by a transformation from personal to impersonal relations. When a natural state develops institutions and organizations that allow elites to treat each other impersonally, a society is assumed to be on the *doorstep*. To sustain and institutionalize impersonal relationships among elites and extend the rights to a larger part of the population three doorstep conditions are

⁵³ Bates (2001) argues in the same direction. The ruler could not make war without the economic help of the ruled, while the ruled demanded better and more efficient services from the ruler in exchange.

⁵⁴ In a criticism of Herbst, Di John (2008) highlights that the analysis does not explain the variation in tax collection capacity within African countries over time and across countries. The different impact of colonial economic development may have had an impact on tax collection capacity.

necessary: the rule of law for elites, perpetually lived organizations in the public and private spheres, and consolidated control of the military.⁵⁵ **While the authors correctly start from the assumption that a transition process has to be explained within the logic of natural states, the question with respect to fragile states remains how to achieve even these doorstep conditions.**

In their recent critical contribution to the dilemmas of state-building, **Paris and Sisk (2009)** emphasize that several authors have independently underscored the importance of state-building for successful peace-building. **Fukuyama (2004)** highlights the problems of weak governance and missing institutions at nation-state level as critical elements for economic and social development. The author stresses as a crucial goal of peace-building, strengthening the capacity of a post-war government. **Chesterman (2004)**, in his analysis of the history and dynamics of internationally-run 'transitional administrations' as well as state-building's dilemmas and contradictions, also emphasizes the importance of establishing sustainable institutions and economic stability. **Fearon and Laitin (2004)** argue that countries with weak governmental institutions are prone to civil war and create an international security risk. Furthermore, the international community is supposed to lack capacity to engage in effective state-building. Finally, **Paris (2004)** highlights the destabilizing effects of political and economic reforms like economic liberalization and marketization. The author opts for the establishment of basic functioning state institutions to manage the destructive potential of economic liberalization.⁵⁶

⁵⁵ North et al. (2009) highlight that the doorstep conditions possibly, but not inevitably, generate incentives for open access in the polity and economy.

⁵⁶ Rotberg (2004) argues that the struggle over viable state apparatus fuels civil conflict and that protracted state weakness leads to a progressive implosion of the state apparatus. Structural and contingent economic factors may further hollow out the state. The primary concern to restore a failed state must be stabilisation and recovery of law and order as well as peace. See also Krasner (2004).

Box 5: Ghani and Lockhart (2008): Fixing failed states

In their prominent contribution to state-building, the authors propose a reorientation in the international response to create capable states. The key to state building is to agree on a goal and the functions of the state to support this objective and then to follow up with a pragmatic search for means of implementation.

The authors bemoan the old order and the idea of sovereignty in international organizations. In their view, a citizen-based approach and a double compact is needed: between citizens and the state as well as between the state and the international community. Furthermore, the importance of new information technology and massive public investment is highlighted. Human capital is critical to development, since in a networked world it is not the memory of particular pieces of information that makes people valuable, but the capacity to recognize emerging patterns.

The authors stress six themes in the context of failed states. First, a prolonged conflict that follows state dysfunctionality produces an institutional syndrome with effects on the economy and polity. Second, peace-making may be more accommodating with regard to opposing parties than creating mechanisms for functioning states. Third, state dysfunctionality often starts in the very wake of a peace agreement. Fourth, the cost of failed politics and poor public policy is immense. Fifth, money is not a critical driver of sustained poverty reduction. Finally, the authors emphasize the relevance of the criminal economy.

Within their framework states need to conduct ten functions: the rule of law, a monopoly on legitimate means of violence, administrative control, sound management of public finances, investment in human capital, the creation of citizenship rights through social policy, the provision of infrastructure services, market formation, management of public assets, and effective public borrowing.

Paris and Sisk (2009) reflect on four possibilities for international actors to handle the problem of state and peace-building.

First, the authors discuss the **counsel of retreat**. 'Let states fail' and allow autonomous recovery, which may allow new forms and centres of political authority. Here the argument is that international efforts to end wars through negotiated settlements can serve to 'freeze unstable distributions of power'. Thus allowing conflicts to sort out winners is assumed to be a surer basis for peace. A second argument would be the rejection of large-scale peace-building on normative grounds as a new form of Western colonialism.

The second counsel concerns **reinvestment**. Thus deeper and longer-lasting international interventions are needed, since the under-commitment of international resources hinders successful peace and state-building.

Third, the authors analyze **the counsel of reorganization**. Here the thrust of the argument is the lack of strategic coherence among international peace-builders. Thus greater coordination among international actors is required to successfully transform conflict-prone countries.

Finally, the **counsel of rethinking** is put forward. More analysis is needed, since international actors have an insufficient understanding of state-building's complexities as well as of the

intrinsic tensions and contradictions. Post-war state-building is conceptualized here as an inherently contradiction-filled enterprise

With respect to international engagement, this paper takes the view that the counsels of Paris and Sisk (2009) are not all contradictory. **Improved strategic coherence among international peacebuilders and more understanding of the inherent complexities are necessary aspects of an appropriate strategy. In addition, this discussion paper argues that 'let the states fail' is not a viable option for the international community.** The counsel to retreat is based either on an idealist or postmodernist approach. The first argues that fragile states need to rid themselves of their colonial and neocolonial legacy, while the latter argues that fragile states work in their own way. **In an increasingly interdependent world, however, fragile states will not develop alone. Finally, the international community bears some universal responsibility for the people affected.**

4. Conclusion

What does the debate tell us about how inclusive growth can be achieved in fragile states? The discussion presented a variety of internal and external structural factors impeding long-term growth in fragile states. Here, we will not present specific recommendations for economic or institutional policy options, which has to be based on a country analysis. In contrast, we will look at general prescriptions for inclusive growth.

The key insight of the economic growth theory is that high rates of accumulation of physical and human capital as well as technical progress may have a positive influence on growth. The critical question is then to explain why fragile states accumulate less capital than others and have lower rates of technological progress.

While neoclassical growth models would predict a ‘catching up’ process, models of endogenous growth allow low levels of equilibrium in income levels and growth. Modern theories of underdevelopment argue that severe distortions and inefficiencies in fragile state markets hinder the adoption of new technologies and a successful industrialisation process. **The key point here is that purely economic constraints may inhibit inclusive growth and could lead to self-reinforcing poverty traps.**

Proponents of the **geography hypothesis** stress the direct effects of geographic conditions on the inputs of production functions or the production process itself. Possible constraints are **climatic conditions, location, and natural resources**. Another point of discussion is the **effect of inequality on economic growth**. While several transmission channels are argued for a negative effect of vertical income inequality on subsequent economic growth, the empirical evidence is ambiguous. On the other side, horizontal inequality seems to be a risk factor for conflict and consequently low economic growth.

Taking into consideration the **new institutional economics and political economy approaches, explanations for poverty traps are based on formal and informal institutional constraints**. The basic economic rationale is here the importance of institutions to lower transaction costs to achieve economies of scale and specialization. For advocates of the institutions hypothesis, the path of economic growth is determined by the quality of institutions. Low-level equilibrium can persist over a long period of time. Institutional path dependence may exist because of network externalities and possible complementarities within an existing institutional matrix. In addition, groups with political power may not be able to credibly commit on reforms.

With respect to the **role of the government for development and possible government failures**, two contradictory positions are emphasized in the debate. **Heterodox approaches** opt for an extended rent-seeking framework which highlights the possible positive social values of rent outcomes for the society. A growth-enhancing governance may manage incentives to achieve rapid technological acquisition and political stability in the context of social transformation. **The main question concerning this approach is whether the governance capabilities are not close to the requirements of the new institutional economics.**

In contrast, the public choice theory severely criticizes the inefficiencies of bureaucrats creating welfare decreasing rent-seeking efforts. **Besley and Persson (2009)** correctly argue that a malevolent view of governments is far too simplistic and places too much emphasis on the use of taxes in redistribution. In addition, this approach does not take in account the fact that suppressing vested interests may not be politically feasible.

An emerging consensus in the debate is that igniting growth may require only a 'small' set of reforms with limited institutional changes. An 'encompassing' authoritarian regime with 'good' economic policy may be pro-poor at the beginning of development in fragile states. To maintain productivity and to sustain development, however, economies have to initiate deeper levels of reforms and to acquire high-quality institutions.

The central question for long-term inclusive growth in fragile countries would then be whether and how a society can transform its institutions at a deeper level to sustain long-term growth. Accepting the position that some kind of democratic political institution is needed to sustain economic growth, the key debate would be on the transition to democratic regimes. **Olson (1993)** correctly denies a simple transition due to a collective action problem. The author refers to some kind of spontaneous emergence when successive individual or group leaders cannot establish another autocracy. **North, Weingast and Wallis (2009)** propose three necessary doorstep conditions: the rule of law for elites, perpetually-lived organizations in the public and private spheres, and a consolidated control of the military. **A first problem is that even then the transition to an open-access order society is not at all certain. A second issue is how a fragile state can even achieve these doorstep conditions.**

A final critical question is whether one also assumes that positive policy interventions would have an impact on inclusive growth in fragile countries. In this context, a **policy hypothesis** would argue that differences in economic growth may also be explained by different approaches to economic policy. The main argument then is that an adequate economic policy in the form of a stable macroeconomic framework can enhance welfare even when set against the background of detrimental geographical and institutional characteristics. **This paper finally argues that the policy, institutions, and geography hypotheses are interconnected as well as complementary and feasible policy recommendations very much depend on country analysis of the specific factors of underdevelopment.**

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