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Chapter 7

AID TO SMALL FRAGILE ECONOMIES: ALLOCATION AND EFFECTIVENESS ISSUES

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ABSTRACT

This chapter summarises research on aid allocation and effectiveness, highlighting the current findings of recent research on aid allocation to small fragile economies. Consistent with international convention, a country is treated as small and fragile if it has a population of less than 1.5 million and it has critically low policy and institutional performance ratings. This chapter looks at various research findings in the broader context of research and analysis on how aid should and is being allocated across all developing countries. In addition, this chapter also looks at types of instruments and their sequencing in fragile states.

1. INTRODUCTION

Does aid work, by increasing growth and reducing poverty? The answer to this question, based on recent research on the macroeconomic impact of aid, evidence from micro studies and field experience, is, in general, a clear yes. Growth would clearly be lower than would otherwise have been the case in the absence of aid\(^1\). This is clear from any objective, comprehensive reading of the aid-growth literature and from recent surveys [see, for example, Hansen 7 Tarp, 2000; Beynon, 2002; Morrissey, 2001]. One can reasonably infer that by implication poverty would be higher without aid. Yet it is also clear that the contribution of

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\(^1\) A brief survey of the literature on aid and growth is provided below in the Appendix.
aid to growth differs across countries: an additional dollar of aid to one country does not have the same impact as an additional dollar to every other country. Burnside & Dollar [1997, 2000] found that aid works better in countries with better policy regimes or, more generally, that its effectiveness in promoting growth was contingent on the quality of these regimes. This very well-known finding has been questioned by some subsequent research. There is, however, an acceptance among researchers that better policies, however defined, should in all probability result in more effective aid. Other studies find evidence of a number of alternative contingencies. These findings have clear implications for aid allocation, for if one wishes to maximise its global poverty-reducing effectiveness, one primarily allocates it to countries in which it has the greatest impact. The Collier & Dollar [2001, 2002] aid selectivity model, discussed in detail later in this chapter, is built partly on this principle. By taking into account recipient country policy and institutional performance in aid allocation, so too is the IDA’s long-standing country allocation system [World Bank, 2003].

The selectivity approach, or more broadly giving preference to countries that can use external resources more effectively in allocating aid, is one that donors are embracing to such an extent that it has become a dominant paradigm in international aid policy and practice. Donors are in general linking aid allocation to assessments of the quality of recipient country policies and institutions, in the belief that aid works better in countries that do better in terms of these assessments. Some donors are concentrating aid on relatively small samples of countries that inter alia are rated higher on the basis of these assessments. But this paradigm does have drawbacks, some of which are receiving increased scrutiny within the international development community. One is the allocation of aid to countries that score poorly in policy and institutional assessments, especially those that are poor and in great need of assistance. These countries are penalised with less aid in a pure selectivity regime.

A specific concern related to the selectivity approach relates to ‘fragile states’. These states have difficult development environments, in that according to conventional wisdom on aid effectiveness they are ‘unable or unwilling to harness domestic and international resources effectively for poverty reduction’ [Torres & Anderson, 2004, p. 1]. At present there appears to be no universally accepted ‘fragile states’ definition. As Torres & Anderson [2004, p.1] note, these states ‘take many forms, and have been defined in various ways’. They can also be referred to as ‘difficult partnership countries’ (DPCs). However, two operational classifications are currently used within the international community. The first considers a state fragile if it is a member of the World Bank low-income country under stress (LICUS) group. The second considers a state fragile if it belongs to the bottom two World Bank

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2 Studies that do not find empirical evidence of the link between policy and aid effectiveness include Hansen & Tarp [2000, 2001], Dalggaard & Hansen [2001], Guillamont & Chauvet [2001], Hudson & Mosley [2001], Lu & Ram [2001], Dalggaard, Hansen & Tarp [2004], and Ram [2003, 2004]. The acceptance that policies generally matter is based on theoretical reasoning, micro studies and field experience. To this extent, much of the debate has been over whether one can validly observe a link between aid effectiveness and policy in the context of the type of econometric exercise conducted by Burnside & Dollar [1997, 2000] and not per se over the relevance of policy for this effectiveness. See Robinson & Tarp [2000], Benyon [2001, 2002], Gunning [2001], Morrissey [2002], Collier [2002], McGillivray [2003a] and Collier & Dollar [2004] for further details.  

3 See Robinson & Tarp [2000], Benyon [2001, 2002], Gunning [2001], Morrissey [2002], Collier [2000], McGillivray [2003a] and Collier & Dollar [2004]. This acceptance is based on theoretical reasoning, micro studies and field experience. To this extent, much of the debate has been over whether one can validly observe a link between aid effectiveness and policy in the context of the type of econometric exercise conducted by Burnside & Dollar [1997, 2000] and not per se over the relevance of policy for this effectiveness.  

4 These studies are cited below, in Section II.
Country Performance and Institutional Assessment (CPIA) quintiles. There is, however, very substantial overlap between these two groups, as a criterion for including a country in the LICUS group is a CPIA score of 3.0 or less. Nations engaged in or recently having emerged from conflict tend to feature heavily among states classified as fragile. Countries that descend into a state of fragility remain in it for decades, and the human and financial costs of this are staggering. Estimated financial costs, for any one country, are well in excess of the current world aid budget [Chauvet & Collier, 2004].

This chapter reviews the different research strands and views in the international development community on (i) how aid should be allocated among developing countries and (ii) how aid is being allocated among these countries. Special consideration is given to research on allocations to small fragile states. In line with international convention, a small country is defined as one with a population of less than 1.5 million. Small countries that are also fragile according to the two classifications mentioned above are Comoros, Djibouti, Gambia, Guinea-Bissau, Kiribati, Sao Tome & Principe, Solomon Islands, Timor-Leste, Tonga and Vanuatu.\(^5\)

The first of the above issues is examined in Section II. It looks at the different allocation models proposed in recent years, including the Collier-Dollar selectivity model and cases for and against aid to fragile states. Special attention is given to absorptive capacity constraints and recent research looking at whether aid can promote policy and institutional reform in fragile states. Section III addresses the second of the above issues. It reports evidence that donors are increasingly taking into account developmental criteria in aid allocation, in particular the notion of aid selectivity. The question of whether fragile states receive aid allocations appropriate to their population and poverty levels and policy and institutional environments is examined. Evidence is shown that most fragile states are under-aided in this sense. Also considered is aid volatility. It is observed that aid to these countries, especially the under-aided ones, is highly volatile. Section IV looks at possible directions for future research and policy.

2. How Should Aid Be Allocated?

Early approaches to the issue of how aid should be allocated among developing countries tended to be based on notions of equity, efficiency or a combination of both criteria. These approaches were not linked in a systematic way to findings from the aid effectiveness literature.\(^7\) This is understandable given the inability of the aid effectiveness literature to provide consistent, reasonably unambiguous results for country level effectiveness. Collier & Dollar [1999, 2001, 2002] changed this state of affairs with their ‘aid selectivity’ model of inter-country aid allocation. This model provides a ‘poverty-efficient’ inter-country aid

\(^5\) It should be emphasised that the research on fragile states that is examined in this chapter makes no distinction between large and small fragile states. As such the conclusions that are drawn and any policy recommendations apply or are generic to both groups of countries. This does however point to a caveat that should be kept in mind while reading this chapter.

\(^7\) The IDA’s country allocation system, mentioned above, had for many years been in part based on recipient country policy and institutional performance, but this was not linked to findings from the research community, but instead on field experience. Kanbur [2004] charts the link between this system and the contemporary aid effectiveness literature, showing how it is consistent with the findings of Burnside & Dollar [1997, 2000] and other studies that show a link between aid effectiveness and CPIA (or similar) scores.
allocation that provides a benchmark guide to donors pursuing poverty reduction as the prime operational criterion. A poverty-efficient allocation is one that minimises the total number of people living in the world below the chosen, international income poverty line. According to the prescriptive Collier-Dollar selectivity model, aid allocated to each country is an increasing function of its poverty level and CPIA score and a decreasing function of its national per capita income. Countries with inferior policy regimes receive less aid in this model, therefore, as these regimes are thought to reduce the impact of aid on growth and thus poverty reduction. The poverty-minimising, optimal allocation is one in which an extra dollar of aid in any given country decreases the number of people living below the income poverty line by an identical amount as in any other country.

The Collier-Dollar selectivity builds on the empirical work of Burnside & Dollar [1997, 2000], in particular the notion that the effectiveness of aid in promoting growth is contingent on the policy regimes of recipient countries. A number of other aid-growth studies provide empirical findings that lend support for additional contingencies. These include the extent of democracy [Svensson, 1999], structural vulnerability [Guillaumont & Chauvet, 2001], the presence of trade shocks [Collier & Dehn, 2001], climatic conditions [Hansen & Tarp, 2001], the extent of political stability [Chauvet & Guillaumont, 2002], the existence of a post conflict scenario [Collier & Hoeffler, 2002, 2004], the presence of a totalitarian government [Islam, 2003], the degree to which aid is fungible across sectors [Pettersson, 2004] and the quality of institutions [Dalgaard, Hansen & Tarp, 2004].

McGillivray [2003a] advocates an extension of the Collier-Dollar model on the basis of some of the preceding findings, involving augmenting it with additional contingencies. McGillivray speculates that this might see more aid being prescribed for countries with not-so-good CPIA ratings. Whether this might see more aid to fragile states is a matter of speculation. The Collier & Hoeffler [2002] finding that, ceteris paribus, aid works better in post-conflict scenarios might on the surface provide a basis for such an outcome. A closer inspection reveals, however, that their finding relates not to countries that have just emerged from a conflict, and which might be classified as fragile, but to those four to seven years into a post-conflict episode and is contingent on the CPIA-assessed quality of the recipient policy and institutional regime. Thus, according to Collier & Hoeffler, aid will not be especially poverty efficient in post-conflict countries with inferior CPIA scores.

A defining feature of the Collier-Dollar selectivity model is that it minimises aggregate global poverty. It does not seek to minimise poverty in each individual country. Reallocating aid from one country to another is globally poverty efficient if the increase in poverty in the former is less in absolute terms than the decrease in poverty in the latter. An alternative approach is to seek to equalise poverty differences or poverty reduction across countries. This lies at the heart of the allocation model implicit in the strategy for achieving the Millennium Development Goals (MDGs), outlined in the UN Millennium Project Report. This strategy involves allocating aid in such a way as to minimise the shortfall between actual levels of MDG variables and their target values, in each country. These targets can in a sense be defined as poverty lines, but defined in spaces or dimensions in not only income but others as well, corresponding to the various MDG variables. The greater the shortfall, and presumably

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7 These contingencies have not been subject to extent of scrutiny to which the aid-policy-growth link reported in Burnside & Dollar [1997, 2000] has. It would be appropriate that they be further scrutinized prior to be incorporated into a selectivity model.
its size, the greater the amount of aid a country can expect to receive. The implicit poverty
efficient outcome is one that equalises the above-mentioned shortfalls across all countries
irrespective of the amounts of aid required to do this in each country. This will result in
different amounts of aid being used across countries to lift one person above the poverty line
if we assume that the effectiveness of aid differs across countries, as is the case. The MDG
strategy is largely blind to this point, implicitly assuming that the marginal effectiveness of
aid is equal across all countries, at all levels of aid. It also does not take into account possible
disincentive effects of increased aid. As Wood [2004] notes, aid can make weak states even
weaker, by reducing the incentives for self-help and diverting effort into rent-seeking.

Cogneau & Naudet [2004] provide an equal opportunity (EOp) model of aid allocation. This model is in part a response to the above mentioned criticism of the Collier-Dollar model,
but unlike the UN Millennium Project Report takes into account differential aid effectiveness
at the country level. Cogneau & Naudet’s analysis is based on the recognition that a country’s
CPIA score (which they call an ‘effort’ indicator) is influenced by structural disadvantages,
over which the country has little or no control. Not to take this into account in the allocation
of aid is thought to be inconsistent with notions of fairness. The Cogneau-Naudet model’s
optimal allocation is one that equalises differences in poverty risk by a chosen point in time
between countries facing different disadvantages but making the same degree of effort. Thus,
countries with lower projected poverty declines get more aid for any given effort. This equal
poverty risk principle leads to an allocation of aid that minimises projected poverty level
differences between countries by that point in time. The point of time in Cogneau & Naudet’s
application is 2015.

A key variable in the Cogneau-Naudet EOp model is an effort variable adjusted for
disadvantage. It is a country’s CPIA quintile that is predicted by its growth prospects of its
region and its initial poverty level. The Cogneau & Naudet prescribed allocation gives more
aid to poor countries than that of the Collier-Dollar model. Fragile states typically are
prescribed more aid by the former as compared to the latter. But for a number of states the
reverse is true, with the former model giving zero aid to them. These outcomes
notwithstanding, the Cogneau-Naudet offers some prospects for providing larger shares of aid
to fragile states than might otherwise prevail, in an objective and scientific manner. The key
question though, is whether the notion of fairness, implicit to the Cogneau-Naudet approach,
results in fewer people being lifted out of poverty.

The Collier-Dollar and Cogneau-Naudet models share an important, common feature:
saturation levels of aid. They result from the recognition of diminishing returns to aid, and
equate to a level of aid at which its incremental impact falls to zero. Diminishing returns to
aid effectiveness have been examined closely by most recent aid-growth studies. This tests for
non-linearity in the aid-growth relationship, with aid being positively related to growth up to
a certain level of aid and negatively related thereafter. That there are diminishing returns is a
seemingly highly robust finding, with almost all studies reporting such a relationship, with
negative returns setting in when the aid inflow reaches anywhere between 15 and 45 percent

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8 Llavador & Roemer [2001] provide a similar analysis. However, it suffers from serious methodological flaws and
prescribes a questionable inter-country allocation of aid. See Cogneau & Naudet [2004] and McGillivray
the approaches discussed in this section.

9 For example, Laos, Papua New Guinea and the Solomon Islands would receive 6.5, 3.2 and 4.8 million dollars,
respectively, from the Collier-Dollar model but under the Cogneau-Naudet model they receive zero aid.
of GDP. This has been interpreted as indicating limited aid absorptive capacities, with recipient governments being limited in the amounts of aid they can use effectively [Clemens & Radelet, 2003]. This issue is especially relevant to fragile states as they will inevitably have very limited absorptive capacities, as conventionally defined. Increased aid to these countries, in line with proposals to achieve the MDGs, could actually reverse poverty reduction. This is obviously a compelling case against additional aid to fragile states.

Collier & Chauvet [2004] look at whether aid can assist policies and institutions to improve in situations in which they are particularly weak, viewing their analysis as an extension of the Collier-Dollar selectivity model discussed above. Two questions were considered, both in the context of the LICUS group. The first was whether aid is significantly effective in promoting policy and institutional turnarounds sufficient to take a country out of LICUS status on a sustained basis. Collier & Chauvet found that two forms of aid — support that achieves an expansion of secondary education and aid in general other than technical assistance - have significantly favourable effects on the changes of a sustained turnaround. Technical assistance was found to have a negative impact on the chances of such a turnaround. The level of aid required to achieve a turnaround, for any typical LICUS, was estimated to be an additional one percent of its GDP per year for five years. In present value terms, this cost is $240.8 million. The estimated payoff, defined in terms of the reduced costs to the LICUS and neighbouring countries (due to spillovers) in terms of GDP foregone, is $3.1 billion.

The second question addressed by Collier & Chauvet was whether aid affects policy during the early stages of a pre-existing reform. Collier & Chauvet addressed this question by looking at countries in the LICUS group that embarked on ‘incipient turnarounds’, defined as a 0.5 point CPIA improvement, asking whether they matured into sustained turnarounds. It was found that both technical assistance and other aid have significant effects on the time which an incipient turnaround takes to become a sustained one. But these effects were quite different in nature. Small amounts of other aid slow down the process of sustained turnaround, but large amounts accelerate it. The threshold at which the effect becomes positive, at which aid begins to accelerate the process, was found to be around 12 percent of GDP. Technical assistance had the opposite effect, being associated with a slowing down of the time an incipient turnaround becomes a sustained one at around 4 percent of GDP.

Collier & Chauvet [2004] also examine the LICUS duration and costs. They estimate that once a country meets the criteria for LICUS status it typically remains so for 69 years. They also estimate that the cost of a country descending into this status, to the country itself and its neighbours, is in present value terms approximately $US100 billion. This is a lower bound cost, and based on a typical LICUS. Most of this cost, which is well in excess of the current annual world aid budget, is met by neighbouring countries. Thirty countries are currently in the LICUS group. There is also the concern that fragile states can descend into conflict.

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10 Heller & Gupta [2002] provide a useful discussion of this issue, along with the related problem of Dutch Disease. Killick [2004] cautions against increased aid to Africa on, inter alia, absorptive capacity and Dutch Disease grounds. Note though that Gomanee et al. [2003], using a general technique specifically designed to detect threshold effects, struggle to find evidence of such returns and therefore question the inferences drawn by previous studies. They do however find evidence of a non-linear impact of aid on growth.

11 This outcome was deemed to have occurred if a country meets each of the following criteria: has a pre-turnaround CPIA score of no greater than 2.5; achieves an increases in its CPIA of 1.4 points above its pre-turnaround nadir; and can maintain a CPIA score of greater than 3.0 for at least five consecutive years after passing the 2.5 point threshold.
Chalmers [2004] estimates that on average for every £1 spend on conflict prevention, £24 of savings are generated. Added to this of course is the loss of life associated with conflict. These findings do not alone provide a case for allocating aid to fragile states. But they would appear to provide a compelling case for finding ways of making aid work in fragile states, given the potential costs of non-intervention, and if so providing more aid to them.

3. HOW IS AID ALLOCATED?

A number of empirical studies have tested for selectivity in aid allocations. Dollar & Levin [2004] provide a comprehensive analysis of this issue, covering aid allocations of 41 donor agencies for the period 1984 to 2002. Based on panel data, they find that selectivity is present in aid allocation, being practiced by most donors, bilateral and multilateral, but that it is a new phenomenon that has emerged since the mid-1990s. Dollar & Levin [2004] also examined the poverty focus of aid, finding that it had increased as well. They found that the donor agencies that are most selectivity-focused also tended to be the most poverty focused. McGillivray [2004a] looks at evidence from 1968 to 1999 time series data, controlling for a range of developmental and donor self-interests. Evidence of selectivity was found in seven of the 10 recipient countries under consideration. For a number of these countries it became increasingly important from the early 1990s.12

The econometric evidence of increased selectivity in aid allocations is consistent with the widespread view that since the end of the Cold War and especially since the late 1990s and early 2000s, donors have given much greater emphasis to developmental criteria.13 This view is further supported by survey research. A 2002 survey of 10 donors, conducted by DFID indicated that increased emphasis is being given to selectivity, defined broadly as encompassing not only the quality of policy regimes but also a range other developmental concerns, such as governance, program implementation and absorptive capacity [McGillivray, 2003a]. Jones, Riddell & Kotonglou [2004] provide a comprehensive survey of donor allocative behaviour, finding that aid allocations and policies have become more poverty-driven as international consensus regarding support for the MDGs has grown. They also found that donors had become more selective as they became more aware of evidence suggesting that policies were important for aid effectiveness. Jones et al. [2004] looked closely at the allocation processes of nine donors, finding five built formal performance criteria (such as CPIA scores) into allocation decisions.14 The World Bank has shown increased concern for poorly performing countries, as evidenced by its LICUS initiative and

12 Dollar’s & Levin’s results appear to be robust with respect to the choice of policy index. Among the indices used was the CPIA. McGillivray’s analysis employed an index combining the inflation rate, economic openness and the central government budget deficit. For Kenya, McGillivray observed a negative relationship between policy quality and aid from the early 1990s, contrary to the selectivity approach. Birdsell, Claessens & Diwan [2002] struggle to find evidence of selectivity in official net resource transfers to sub-Saharan Africa, although there is a case for suspecting that this result is an outcome of the empirical methods employed by this study.

13 More recent studies, examining data extending to the mid- to late-1990s, do though find that donor non-developmental interests remain important determinants of aid allocation. See, for example, Bertheremely & Tichit (2002) & Feeny and McGillivray [2004]. These studies do, however, report a statistically significant, negative relationship between aid and recipient country income per capita, indicating that donors give preference to poorer countries in allocating aid. This is quite a robust result.

14 The donors were Australia, Canada, the European Commission, France, Germany, Japan, the Netherlands, Norway, Sweden, the United Kingdom and the United States.
the IDA’s framework for aid delivery to conflict-affected countries [World Bank, 2002; IDA, 2004].

Jones et al. [2004] examined whether greater selectivity had led to a bias against failed states and defined in terms of LICUS group membership. It was concluded that the potential for such a bias between 2000 and 2002 was offset due to not only the provision of humanitarian aid, but by the “increasing attention to those failed or failing states that are regarded as significant for regional and global security and geo-political reasons” [Jones et al., 2004]. Evidence presented in partial support of this contention was that the LICUS group had received increased shares of total aid from the nine donor agencies under consideration between 2000 and 2002. This is broadly consistent with the finding of Nunnenkamp et al. [2004], that shares of both total bilateral and total multilateral aid to the bottom two CPIA quintile groups remained approximately constant between 1993-98 and 1999-2002. Jones et al. [2004] note, however, that some difficult partnership countries could be considered as “aid orphans”. That is, they received very low amounts of aid, in part because the costs of state failure within them was not of sufficient consequence to the international community or to particular donors to justify larger aid amounts. This is in part reflected by a lack of diplomatic engagement, and is made worse by a lack of media attention in many fragile states.

Levin & Dollar [2005] conduct a closer, empirical examination of aid during 1992 to 2002 to difficult partnership countries (DPCs), defined as being those belonging to the bottom two CPIA quintiles. Levin & Dollar look at aid to these countries in the context of their population, poverty, and policy and institutional performance levels. It was concluded that the difficult partnership countries received 58 percent less bilateral aid and 34 percent less multilateral aid than predicted by these variables. Overall, these countries received 43 percent less aid than predicted by their population and poverty levels and policy and institutional environment. This is a particularly incisive finding, and more meaningful than the shares of aid reported above. The extent of under-aiding, in the context considered by Levin & Dollar, varies tremendously among the DPC group. Some countries received substantially less aid than predicted and others received far more. Post-conflict DPCs were found to receive more aid than predicted, and this gap has increased after 9/11. Among those countries receiving less aid than predicted were those that are aided by a relatively small number of donors. The over-aided recipients (termed as ‘aid darlings’) mainly included small countries.

Aid flows have been shown to be more volatile than other sources of developing country government revenue [McGillivray & Gemmell, 1998]. High aid volatility makes budgetary policy more difficult and can increase exchange rate variability, thus potentially offsetting any positive impacts of aid [Bulff & Hamann, 2003; Edwards & van Wijnbergen, 1989]. Levin & Dollar [2005] also examined the volatility of aid per capita to the DPC group. Specific for fragile states would be that results take longer to materialise in these environments, therefore volatility is particularly damaging. It was found that aid to the DPC group was almost twice that of other low-income countries. This result was not altered after controlling for the specific circumstances faced by DPCs, namely rapid changes in policies and institutional strength and the onset or cessation of conflict. There is, however, volatility heterogeneity among the DPC group, and this is of serious concern. The aid volatility faced by the darlings, as defined above, is very close to that experienced by other low-income countries. Strikingly, the volatility of aid to ‘orphans’ (under-aided countries) is more than twice that of the darlings. It is therefore the volatility of aid to the orphans that pushes the average volatility of the DPC group to such a comparatively high level.
4. FACTORING-IN FRAGILITY: WHERE TO FROM HERE?

This chapter has focussed primarily on the research literature on aid allocation and related work on aid effectiveness, taking a special interest in what the literature says about fragile states. It is reasonably clear, from the chapter’s literature survey, that while research on policies and institutions is clearly relevant to these states, the fragile state-specific literature is still an emerging one. Collier & Chauvet [2004], Levin & Dollar [2005] and Jones et al. [2004] provide important and comprehensive information, but more fragile state-specific research is clearly needed to sufficiently address the question raised above. This initially, and fairly obviously, requires agreement over the criteria for classifying countries as fragile states. As mentioned earlier in this chapter, a consensus on an appropriate definition of this term has not yet been achieved. One also needs to acknowledge that fragility is primarily a matter of degree, not of kind. One should not, however, become bogged down on this issue, as that mitigates against further research and policy development and implementation. A reasonably expedient, but seemingly valid approach is that adopted by the DAC, which assigns the fragile state classification to a country if it is in the bottom two quintiles of the CPIA or has not been rated by the World Bank.

The key questions that then need to be addressed are whether aid, in all of its current or historical forms, is either ineffective or not sufficiently effective in fragile states, as defined, and if so, how can it be made to work more effectively in them. Collier & Chauvet [2004] provide an insightful response to this question, by looking at the impact of aid on policy and institutional reform. One might infer from their results that by being positively associated with such reform, aid to fragile states can be justified on effectiveness criteria. But their analysis is a partial one, to the extent that it does not look at this relationship in the context of a selectivity model, nor relatedly does it look at implications for growth and poverty reduction. It is also a preliminary one, requiring further investigation.

Answering the preceding questions should provide subsequent information on whether these countries are under- or over-aided and, in particular, on their absorptive capacities. It might also tell us, for example, whether the augmentation of the Collier-Dollar selectivity or Cognacu-Naudet EOp models, discussed in this chapter, would see changes in aid allocations prescribed for fragile states. Augmenting the selectivity model, for instance, would see more aid to fragile states if they are characterised by stable political regimes, trade shocks, structural vulnerability and the other characteristics mentioned above. Such an augmentation rests on results from research on links between aid and growth. But it needs to be recognised that growth is not the only potential benefit of aid. Prevention of instability and conflict, improvements in human rights, avoiding deterioration of human development indicators and preventing spillovers on neighbouring countries are other benefits. We need to learn more about the impact of aid on these factors, especially as they apply to fragile states.

Donors can factor in the results of this research as they become available. But they need to move more quickly than this given the magnitude of issues faced with respect to fragile states, the costs of conflict prevention and a return to violent conflict among them. Three issues emerge.

The first concerns the issue of under- and over-aided fragile states (the orphans and darlings, respectively) needs to be addressed. As mentioned, the small fragile states tend to be in the darlings group. This could involve consideration of: (i) donors agreeing on an annual
discussion of their "partner country" lists to establish where some countries are in danger of losing all or almost all bilateral partners; (ii) compensatory multilateral mechanisms, with some multilateral agencies playing the role of residual by balancing out the decisions of others; (iii) more explicit tasking and training of diplomatic missions in development dialogue, and; (iv) use of mechanisms such as the proposed UN peace-building commission to maintain a focus on orphans.

Second, aid volatility to all fragile states (both small and otherwise) must be checked. This is arguably of utmost importance for small states, given limited capacities to absorb increased flows due to the size of their economies. This is both a matter of individual donors being more conscious of year-on-year variation in aid allocations, but also for greater co-ordination among donors. This co-ordination could involve: (i) longer term partnership agreements, possibly facilitated through sector programs; and (ii) compensatory multilateral mechanisms, specifically focused on sector programs in the "long-term" sectors such as health and education, allowing other types of aid to be more variable.

Third, diminishing aid returns and related absorptive capacity constraints need to be addressed urgently. The literature on aid tends to assume that all aid is provided via governments, or that donors work with governments rather than working around them. Empirical evidence of diminishing returns is based almost entirely on aid flows which have gone to recipient country governments. Diminishing returns will in principle always be an issue in all countries; an economy can only efficiently absorb aid up to a particular level. But clarity is required over the saturation levels of aid that apply in fragile states, and ways of increasing the optimal share of aid in GDP need to be considered. One method of addressing the second of these issues is to allocate aid via non-government channels, such as NGOs, the private sector or 'independent service authorities'. It can be the case that operating through these channels can make aid effective even when policy and institutional settings are deficient, prior to reforms. These channels have been considered in the literature [see World Bank, 2002; ODI, 2004; Collier, 2002 and Collier & Dollar, 2004]. One can and should explore these channels further, as they apply to fragile states.

ACKNOWLEDGEMENTS

An earlier version of this document was written with the assistance of Sophie Pongracz, from Poverty Reduction in Difficult Environments Team of the UK Department for International Development (DFID) as a background paper for the Senior Level Forum on Development Effectiveness in Fragile States, held in January 2005 at Lancaster House, London. It was commissioned by DFID for the Learning and Advisory Process on Difficult Partnerships of the OECD-DAC. The author is especially grateful to Sophie Pongracz, but also to Tony Addison (WIDER), Michael Anderson (DFID), Sarah Cliffe (World Bank), James Gilling (AusAID), Paul Isenman (OECD), Max Willis (AusAID), Adrian Wood (DFID), Peter Verseg (AusAID), for very useful comments, suggestions, background discussions or information. The usual disclaimer applies.
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