

Challenges and Policy Tradeoffs of institution building in a context of fragility: A synthetic and focused review¹

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1) Introduction

This review surveys the challenges of institution building in fragile states. We discuss the basic tradeoffs identified in the literature to develop policies, institutions, and governance arrangements that promote socio-economic development in a context of fragility. While it has been described in the literature under various denominations (state building, institution building or capacity building²), the central issue is to address the lack of capacities that typically characterize fragile states.

Reflecting a large consensus in the academic and policy literature, two preliminary remarks need to be made. First, the concept of fragility is an ambiguous concept which encompasses huge variations in terms of country characteristics. Therefore, it is important to acknowledge the specificity of each country, in particular with respect to the constraints of capacity and political willingness in institution building. Second, the concept of fragility should also be viewed as a dynamic process in which countries move along trajectories from stability toward conflict, crisis, and/or failure; and emerge from crisis toward recovery and stability. This process can be non-linear and asymmetrical (OECD 2007). A typology of fragile states following such perspective is for instance the one developed by USAID (2005) that concentrates on pathways in and out of crisis along different scenarios: deterioration, post-conflict transition, arrested development, and early recovery.

¹ *The views expressed in this paper are those of the author, and should not be taken to be the views of the European Report on Development or of the European Commission DG Development.*

² see for instance the OECD-DAC "Principles for Good International Engagement in Fragile States and Situations" which prioritise state building as the central objective of international partnerships in fragile situations and in countries emerging from conflict or the World Bank Post Conflict Fund and LICUS Trust Fund created to deliver grants quickly to post-conflict or fragile countries while strengthening their institutions.

One may then essentially organize the discussion on institution building in fragile states along two main questions: a) What are the core functions of the state that need to be targeted and strengthened for institution building? b) What are the policy tradeoffs associated with institutional building? We turn to each aspect in the following sections. Section 2 discusses the core state functions as identified in the literature. Section 3 surveys the standard policy dilemma encountered in state building in fragile contexts. Finally, section 4 and 5 focus on two recent areas where interesting policy tradeoffs have been identified: political settlements and power-sharing arrangements, and international integration and institution building.

2) Core state functions, policy targets and processes

Critical to the process of institution building is the recognition of a set of core state competencies that need to be strengthened and supported by policy intervention (USAID (2005), Brinkerhoff 2007a) and 2007b), OECD 2007, Whaites 2008). Though they take different labels in the literature, they can be categorized along three main dimensions:

- i) *Surviving functions: Control, Security and Protection*. These include the capacity of the state to exert (at least on a given geographical territory) the “monopoly of violence”. It also includes the provision of security and protection of people and property and the effective implementation of the rule of law (Brinkerhoff 2007b), Whaites (2008) and DFID (2008) also include the capacity of raising revenues to sustain the functioning of the state.
- ii) *Delivery of basic public goods*. This relates to the effective provision of basic services (e.g., health, education, and infrastructure) and the efficiency, capacity and transparency of public policymaking, regulation and fiscal arrangements.
- iii) *Political legitimacy and the Social Contract*. This dimension concerns the organization of public and social governance systems, the implementation of democratic political principles, and the establishment of political representation and inclusiveness that help build a legitimate relationship between the state and civil society.

i) Surviving functions: Control, Security and Protection.

Effective control of violence and law implementation are important challenges of states in deteriorating situations. In post-conflict situations, a key issue concerns the so-called security sector reform (SSR). Along this dimension, recent comparative work done within the Crisis States Research Centre (CSRC 2005, 2006) highlights the crucial importance of ensuring the loyalty and effectiveness of security forces to withstand challenges from non-state forces. This requires the capacity to provide regular pay and adequate welfare (Hesselbein et al. 2006). Effective SSR also requires a mix of rebuilding, professionalizing, reforming, and dissolving ex combatants. In this respect, Disarmament, Demobilization, and Rehabilitation processes (DDR) present specific challenges that go beyond simple administrative and political reorganization. Indeed, it also involves the capacity to generate employment opportunities that can provide attractive economic alternatives to “war economy” occupations like crime, banditry and recruitments in “non state” militias.

Another important challenge with respect to SSR is civilian oversight and accountability of security forces through the implementation of well functioning justice systems. While international post-conflict reconstruction assumes that the goal for security and justice is nationwide integration into formal institutions, such reforms can only be achieved through sustained and long-term effort. In the transition process with limited formal state institutions available, informal community-based institutions of security and justice based on traditional practices may also be important building blocks. As noted for instance by Brinkerhoff (2007b) in the case of the Bougainville separatist uprising in Papua New Guinea³, involving local civil society actors can significantly contribute to the building of conflict resolution capacity. Exploiting the complementarities between informal dispute settlement institutions and formal justice systems can then be used as a “bottom-up” strategy of institution building that mitigates the often criticized “state-centered” approach to state building (Di-John (2008)). Additionally, this strategy may generate additional positive spillover effects as it may form the legitimate basis for future dispute settlements in other fields unrelated to armed conflict (property right or land disputes, household conflicts)

Among survival functions, some authors include the capacity of revenue generation (Whaites (2008), DFID (2008)). This is obviously an important element to sustain an effective and trustworthy security and justice sector. Ways of raising revenue may have however important implications for

³ See also Böge et al. 2004) and Howley (2002)

state building capacity. It is suggested in particular that taxation by creating closer linkages with society and raising expectations of accountability, is likely to induce more responsive state-building. On the other hand, in a context of weak institutional revenue management capacity, natural resources windfalls are more likely to induce rent-seeking behavior, corruption and be therefore de-stabilising. Taxation however can also be destabilising if obtained taxes are misallocated or spent through corruption and resulting expectations are not met (DFID 2008). This suggests that the contribution of raising revenue to institution building depends also on the initial cluster of institutions that already exist and on the parallel evolution of these institutional dimensions.

ii) Effective public goods and service delivery

Building capacity along this dimension concerns essentially improving the effectiveness and efficiency of the public sector. This involves investment in public infrastructures and provision of services like health and education. Also, it relates to the functioning of effective economic management processes and adequate regulatory frameworks promoting economic growth and facilitating the breaking of the poverty-fragility trap. In fragile states, one important constraint is the so-called “Two-track problem”, namely the fact that it is often necessary to support service delivery out of several non state agents (NGOs or private firms) which do not have the same objectives, timeframe, or capacity as public institutions. This implies a number of policy trade-offs that we discuss later.

iii) Political legitimacy and the Social Contract

It is widely recognized in the literature that a minimal degree of legitimacy is a necessary condition for state stability (Brinkerhoff (2007b), OECD (2007), DFID (2008)). Building legitimacy refers to the creation of public expectations and acceptance of a governing regime as correct, appropriate, and/or right. Legitimacy has various domestic forms and sources that vary according to context and may not necessarily coincide with a particular model of democratic legitimacy. As mentioned by OECD (2007), sources of legitimacy include: i) *performance legitimacy* that arises from effective and equitable service delivery; ii) *belief-founded legitimacy*, derived from socially accepted beliefs about the rightful source of authority, derived for example from the principle of popular sovereignty, moral authority or prior historical dynamics; and iii) *process legitimacy*, emanating from for example rule of law and/or appropriate accountability mechanisms, participation and inclusiveness. Finally,

legitimacy can also derive from international recognition and support. Related to this, the concept of “expected functions” of Whaites (2008) and DFID (2008) also clearly overlaps with the notion of legitimacy, as it involves the way public expectations on specific state functions are adequately matched and fulfilled by state institutions.

One important notion through which the literature characterizes the process of legitimacy building is the establishment of a social contract binding civil society and the state. In this respect, OECD/DAC provides a helpful definition of the social contract in the context of fragility and state building. It defines the social contract as emerging from the interaction between three elements: a) expectations that a given society has of a given state; b) the state capacity to provide services, including security, revenue generation and control of territory to provide these services; and c) elite that manage state resources and the capacity to fulfil social expectations. This definition emphasizes the importance of political processes through which state-society relationships are framed and institutionalised, and it underlines the role of legitimacy in shaping expectations and facilitating political settlements. This definition also recognizes the dynamic nature of the agreement and the role that informal, traditional, ethnic and cultural ‘institutions’ may have on the shape of the social contract.

iv) Complementarities, Fragility Traps and Target Selectivity

An important feature of the aforementioned core state functions is the fact that they exert on each other strong spillovers and complementarities, feeding back on each other. For instance, security and territory control is an essential input for an effective public provision of basic services like education and health. In return, investment in human capital stimulates economic growth and employment creation. This creates economic opportunities and increased expectations that standards of living will improve. This in turn lowers the incentives for citizen (including demobilized ex-combatants) to engage in crime or be recruited into insurgency, and therefore facilitates Security Sector Reforms.

Similarly, legitimacy contributes to revenue raising by reducing the political and economic transaction costs of taxation. This provides additional state resources for delivery of public goods and benefits for people, and in turn reinforces political legitimacy.

The existence of complementarities between core state functions implies that improving one dimension is likely to facilitate improvements along another dimension, and vice-versa. Conversely, the effectiveness of institution-building in one dimension may be reduced by the existence of weaknesses in other dimensions. In economic terms, one can say that there are “social increasing returns” in capacity building across core state functions. An implication of this is the fact that it can generate the existence of fragility traps in which countries may have difficulties escaping.

Given the limited resources available in fragile contexts, another implication is the crucial challenge to trigger a virtuous process of institution building and, consequently the issue of target selectivity and sequencing of instruments. Though the literature does not provide definitive answers to this question (World Bank 2006a), some elements of responses are suggested by recent research.

For instance, looking at the effect of aid on the probability of turnaround for a LICUS status country, Chauvet and Collier (2004) find that technical assistance aid prior to turnaround has no significant effect on the prospect of turnaround. On the other hand, all aid other than technical assistance has significantly favorable effects on the chances of a sustained turnaround, in particular if this could generate an expansion in education. Conversely, their analysis suggests that both technical assistance and other aid have significant effects on the time which an incipient turnaround takes to become a sustained turnaround. For both the relationship is non-linear. However, while technical assistance is subject to diminishing returns, the non-linearity for other aid is dramatically different and subject to increasing returns to scale. This suggests some implications on optimal selectivity and sequencing of aid for fragile state depending on the willingness to reform of the country:

- a) Before having the country engaged into some reform stance, use other aid, especially for post-primary education, to build the conditions for reform.
- b) At the time of early commitment for reform, rapidly provide substantial technical assistance.
- c) At the Peak stage of reform, technical assistance should be scaled down and replaced by large aid programs.

How far these guidelines can be implemented operationally however remains unclear. In particular, which agency or agencies to target, and within those organizations, how to set priorities, what is the robustness of the prescription to various post-conflict and fragile situations in Africa are questions that remain to be answered.

3) Tensions and Policy Tradeoffs for capacity building

i) Models of policy tradeoffs in institution building

Various models or categorizations have been developed in the literature to underscore a number of tensions and policy tradeoffs of institution building in fragile states.

For instance, Brinkerhoff (2007b) suggests an operational model of capacity building in which typical targets relate to weaknesses in five fields: i) Resources, ii) Skills and knowledge, iii) Organization, iv) Politics and power, v) Incentives). In this model, three intersecting dimensions tend to articulate these targets and are the sources of capacity building dilemmas and trade-offs: 1) the time required to achieve an increase in capacity, 2) the degree of difficulty and complexity associated with developing capacity, and 3) the magnitude of the change involved in the intervention. All three dimensions tend to increase as targets to capacity building move from field i) to field v). By linking scope of change to time and difficulty/complexity, the model reveals where trade-offs may arise. Some tradeoffs are associated to “ways” to build institutions (like for instance the “Doing vs Building capacity” dilemma, or the “Two-track” problem of state vs non-state service provision). Others connect to the *timeframe* of the policy intervention (Immediate reconstruction vs long-term development, immediate security vs long-term stability). Finally, some tradeoffs are associated to the *type of agents* involved in institutional building (Central vs Local Government, External actors vs local capacity)

Similarly, the Research Partnership on Post-war State-building (RPPS) project emphasizes some basic contradictions and dilemmas of policy intervention in post-conflict situations (Paris and Sisk (2007)). In particular, five key tensions and contradictions in state building in fragile contexts are identified:

- Outside intervention is used to foster self-governments
- Foreigners are involved in defining “legitimate” local leaders
- Universal values are promoted as a remedy to local problems
- State-building requires both a clean break with the past and a reaffirmation of history
- Short term imperatives often conflicts with longer-term objectives.

These tensions are the underlying source of several policy dilemmas that again can be classified along five dimensions:

- Footprint dilemmas (related to the degree of intrusiveness in the domestic affairs of the country)
- Duration dilemmas (related to the length of external intervention for state building)
- Participation dilemmas (related to the degree of inclusiveness of the political settlements promoted by the policy intervention)
- Dependency dilemmas (related to the degree of dependency of the country on external assistance and aid)
- Coherence dilemmas (related to the degree of policy coordination (organizational coherence) and policy objectives and values (normative coherence))

ii) The security sector

Given its importance for post-conflict countries, the security-justice sector has attracted specific attention in the literature. An important policy tradeoff in this area relates to the implementation of transitional justice in a post-conflict situation. Recent research (Snyder and Vinjamuri 2003), ICTJ and DFID (2007)) identifies some of the limitations and challenges of different approaches in this sector. Transitional Justice mechanisms (like criminal and civil prosecution; truth commissions; reparations and amnesties contribute positively to legitimacy building and correct for key injustices that contributed to conflict. At the same time, though they have to be implemented in contexts of conflict prevention which require negotiated settlements with some of the perpetrators of injustice themselves, implying therefore the risk of frustrated expectations and mistrust of the victims and conflict-affected populations. In this respect, the joint study ICTJ and DFID (2007) discusses the challenges that the transitional justice trade-off pose to the international community. It suggests the development of a justice sensitive approach to security sector reform (SSR) with a holistic approach compatible both with the need for justice for all victims, and conflict prevention and protection of civilians.

iii) Political Economy of reform and ownership in fragile contexts

As mentioned in the literature (DFID (2005)), fragile states can be categorized along the two dimensions of capacity and political will. Sustainable institution building is then an endogenous process engaging both features. Important political economy dimensions then arise to determine the

feasibility of particular reforms and policy tradeoffs associated to institution building. Indeed, some constituencies disagree on the desirability of particular policy interventions. Individuals and so called spoiler groups engaged in the crime sector and the shadow economy, benefit from fragility and have a strong interest in prolonging crisis and instability, for various economic and political reasons. At the same time, given the underlying uncertainty of the reform outcome, a majority of agents may remain passive and hesitate to commit themselves to either reformers or to “spoilers”. Political agreements designed to end conflict and re-establish security, create incentives that influence subsequent policies and reform processes. Groups strike deals with expectations of the advantage they might gain in the process of future governance. These deals may exclude or disfavour other individuals whose commitment and resources would be needed to support and implement sustainable policies in the future (see GTZ (2004)).

A recent paper emphasizing the previous political economy considerations is Chauvet and Collier (2006). It develops a theory of reform for fragile states in which several characteristics of the society might potentially be the binding constraint on change and why poor governance and policies might be persistent. More precisely, the authors identify four characteristics along which the “willingness vs capacity” dimensions and reform constraints can be articulated:

- Preference congruence between the elite and society (namely how far the interests of the elite may or may not coincide with the interests of the society)
- Knowledge and information (namely how those with decision making power may or may not understand how their own economic interest is best served by government choices)
- Power structure and democratization (namely whether the elite has the capacity to make her interests prevail in a struggle with the rest of the society)
- Technical capacity (namely whether the civil service may or may not have the technical and organizational capacity to plan and implement reform).

The study provides therefore a framework to identify the complete conditions under which a reform will occur and which constraints may be binding and preventing reform. Applying this framework empirically to the case of “failing states”⁴ that embarked upon ‘incipient turnarounds’⁵, Chauvet and

⁴ A “failing state” is defined as a low income country classified as such by the World Bank and that according to the World Bank governance and policy rating, the Country Policy and Institutional Assessment (CPIA), has a value of less than 2.5 for four consecutive years.

⁵ An “incipient turnaround” corresponds to one in which from the low-point of being a failing state the CPIA improves by at least 0.5.

Collier attempt to explain which of these “incipient turnarounds” matured into a “sustained turnaround”⁶ and how the role (and type) of aid may help break some of the constraints for sustained reforms. Their results suggest that timely and appropriate aid significantly increases the chances of a sustained turnaround in a failing state. Also the analysis concludes that the evidence is consistent with the presumption that the normal binding constraint for reform is ‘political will’ due to some incongruence between elite interests and those of the wider society.

4) Political Settlements, Power sharing and Long term Democracy Building

Political settlements are the underlying foundations of the structure and functioning of the state. They are based on a common understanding of the different parties that their interests are served by a specific organisation of political power (DFID 2008). When these settlements reflect a legitimate form of representation and responsiveness, they contribute to preventing or reducing the risk of conflict (OECD (2007)). However, to be able to avert violent conflict, political settlements cannot be static and must be able to absorb social change (DFID (2008)). In a context of fragility this may be difficult, especially when the process of change is exclusionary and controlled by elites defending their interests. As emphasized for instance by Vallings and Moreno-Torres (2005) weak institutions are the central driver of fragility and states whose political systems and institutions are in some form of transition or have combinations of democratic and non-democratic institutions have much higher risk of state failure and fragility. (Goldstone et al (2004)).

Related to this, an important question concerns the most appropriate form of political institutions for post-conflict and fragile states. In this respect, one of the most commonly discussed political mechanisms for post-conflict states is *power sharing arrangements*. The theoretical rationale for such mechanisms comes from consociational theory which argues that certain political institutions perform better than others in promoting smooth political interactions in divided and plural societies. Consociational institutions include features like proportional representation (PR), mutual veto

⁶ A “sustained” turnaround corresponds to the CPIA passing the 3.0 threshold with an improvement of at least 1.5. for at least two years:

between majority and minority groups in government decision-making, and autonomy granted under federalism. These characteristics are argued to promote democratic cooperation between various linguistic, religious, or ethnic communities living within the same boundary of sovereign states (Lijphart (1977)). Originally developed to explain democratic stability in Western European plural societies, proponents claim that such institutions can be applied to establishing peace and democracy in countries emerging from violent civil (Lijphart (2002)). In particular, power-sharing arrangements are generally thought by the international community as the most effective institutional tool for the peaceful resolution of civil conflict. Following the logic of consociational theory, sharing executive and electoral seats as agreed upon by all warring parties can reduce the security dilemma between combatants. Also granting significant autonomy to territorially concentrated rebels is a solution to stop the fighting immediately, though it may lead separation demands in the future. These power-sharing institutions are expected to promote cooperative behavior of former warring parties by giving them stakes in government decision-making. This should ultimately contribute to the promotion of democratic governance.

While power sharing arrangements do contribute to negotiated settlements out of civil war, critics of consociational theory suggest however that these agreements are likely to reinforce pre-existing ethnic, religious, and linguistic cleavages. It is argued that under PR systems, party leaders have less motivation to appeal for voter support outside of their own constituencies than under alternative electoral systems, leading to political fragmentation. As well, the federalism dimension of consociational institutions can lock-in preexisting cleavages within the boundaries of subnational units. In the case of post-conflicts situations, power sharing arrangements therefore may have a tendency to lock war-induced cleavages into post-war political structures. The persistence of wartime cleavages leads to deadlocks in governmental institutions, hinders the development of state capacity necessary for post-conflict peaceful democracy, and may degenerate into the re-emergence of violent break-ups (Roeder (2005); Reilly (2005); Bunce and Watts 2005).

Recent research on this topic provides mixed results. Some authors find a positive effect of power sharing arrangements on sustained post-conflicts situations (Hartzell and Hoddie (2003), Mukherjee (2006)). Others provide evidence that military power-sharing agreements associated to rebel-military integration do not provide effective peacebuilding mechanisms after civil war (Glassmyer and

Sambanis (2006)). Recently, Kwan Jung (2007) also suggests contradicting results. Extending the Sambanis's (2004) civil war list up to 2002 by using *Keesing's Record of World Events* and the Uppsala Conflict Database (UCDB), the analysis shows that the effects of PR and federalism is mildly positive on the establishment of sustainable peace and democracy when looking at all post-civil war countries. However, the evidence gets reversed when considering only negotiated settlement to civil war: the effects of power-sharing institutional arrangements significantly delay the transition to democracy after civil war. While the analysis presents technical caveats due to small sample size and endogeneity issues, it also suggests that the environment in which the power sharing arrangement is implemented can also be a crucial omitted dimension affecting the effectiveness to sustain peace and democracy transition. This evidence is consistent with a potential trade-off between political institutions well designed to end civil wars and institutions good for promoting democratic governance in the long run.

The conclusions of the research project on "Power Sharing and Civil Conflicts" undertaken by the Center for the Study of Civil War (CSCW) are also consistent with the idea that environmental characteristics are important for the successful implementation of power sharing arrangements (Gates and Strom (2008)). Analyzing all 24 power sharing agreements signed in the world since 1989, the study finds that power sharing is more likely to induce stable peace when the parties are evenly matched and the cost of war is high. When the parties are imbalanced and the cost of conflict is low, then power sharing implies non proportional distribution of power and may at the same time radicalize the weaker party. Interestingly, in situations of extreme asymmetry combined with an external security enforcer (such as the UN peacekeeping forces) power sharing arrangements disproportionately resulted in stable peace.

5) Fragility and Challenges of Institution Building in a Globalized World

States do not operate in isolation, and international drivers of fragility are important features of the problem. Globalization and international trade integration can therefore be the sources of important policy tradeoffs for capacity building in fragile situations.

While economists agree that trade openness is likely to generate global gains from trade, the distribution of these gains may be conflict generating and destabilizing. The structure of comparative advantage of the country can affect this dimension. Indeed, the analysis of recent conflicts suggests that the exclusion of some threatening groups from the sharing of the resources of the state is made more likely when the country relies on mineral exports than when it relies on agricultural exports. In the African context, examples like the Biafra war in Nigeria in the late 1960, the civil wars in Angola and in the Democratic Republic of Congo abound. For instance, Collier and Hoeffler (1998) provide econometric evidence that the share of mineral exports in GDP affects significantly the incidence of civil wars. On the contrary, agricultural or industrial exports, the production and benefits of which are widely distributed across geographical areas, ethnic groups, or urban centres, do not seem to enhance the chances of civil violence erupting.

Recent evidence of a potential openness tradeoff in fragile situations with a focus on African countries is provided in the literature. Baliamoune-Lutz¹ (2008) for instance examines the contribution of institutions, social cohesion, and trade to development (per-capita income) with an emphasis on fragile states in Africa. The results indicate that there is an inverted-U shape relationship between openness to trade and income in fragile states, suggesting that beyond a certain level, openness to trade may actually be harmful to economic performances in fragile states. These results are consistent with some former analysis (Baliamoune-Lutz and Ndikumana (2007)) using panel data from 39 African countries on the period 1975-2001 and finding that institutions play an important role in the impact of trade openness on economic income. More precisely, the analysis shows that the effect of better institutions on trade effectiveness is negative at low levels of trade and positive at higher levels of trade.

Looking also at the impact of the structure of trade on economic outcomes, Baliamoune-Lutz (2008) discusses the effect of export diversification. The analysis suggests that, while export diversification is negatively correlated to growth performances in Africa, export diversification however enhances the growth effects of trade openness. These results indicate that, at least in the short run, a trade-off may exist between trade liberalization and capacity building. Indeed, if a fragile state tries to improve its openness to trade, it may wind up with lower per-capita income which may lead to increase poverty and further fragility. The medium-run solution would be to induce a shift in the

pattern of trade of the country and/or promote a redistribution of the gains from trade in ways which are less conducive to conflicts in the economy.

While fragility may affect the effectiveness of trade openness on economic outcomes, conversely, trade liberalization may also impact the degree of fragility of a particular country.. In this respect, two conflicting views tend to appear in the literature. The first one conceives economic problems as the source of conflicts, instability and civil wars. According to that view, trade openness brings benefits and stimulates growth and therefore should contribute to peace and internal stability. Recent quantitative cross-country studies tend to support this perspective and indicate that economically integrated countries are more stable than autarkic ones and less likely to experience civil wars (Bussman et al. (2003), de Soya and Wagner (2003), Hegre et al. (2003)). The alternative “anti-globalization” perspective argues that foreign trade liberalization has negative distributive consequences that may undermine the social fabric of a society and trigger therefore conflicts, instability and fragility.(Brennan (2003), Stiglitz (2002)). Focusing specifically on Sub-Saharan African countries which have been particularly prone to civil conflicts, a recent paper by Bussman, Schneider and Wiesehomeier (2005) suggests a possible trade-off reconciling the previous conflicting views. The authors first develop a conceptual framework suggesting that trade openness has long term socially stabilizing effects in developing countries as it is likely to generate benefits to a majority of the population (unskilled workers). However, trade liberalization may also have short term conflict prone effects as immediate losers may oppose the process and trigger violent reactions. The paper then examines the validity of this framework looking at the effects of trade openness and trade liberalization on the outbreak of internal wars in 37 sub-Saharan African countries for the period 1980-2000. The empirical results tend to support the view that economic openness has a positive effect on peace and stability, once the restructuring of the economy is over. On the other hand, the analysis also indicates that trade liberalization may increase the risk of civil war and conflict during the implementation of the reform measures.

This type of results again suggests potential policy trade-offs between the short term risks of trade reforms and the long term gains from openness. One possible solution to such trade-offs is the implementation of compensation schemes to immediate losers, in order to reduce the short run risks of political instability and allow enough time for the economy to reach the long term situation in

which enough individuals benefit from the reform. Obviously, the capacity to implement such compensation mechanisms relates then directly to the issue of institution building in contexts which are initially fragile

Finally let us mention also beyond international trade, another dimension of globalization that interacts with fragility and can give rise to important policy trade-offs: for institution building: Foreign Direct Investment (FDI). FDI plays a special role as a source of financial resources and technology transfer to the private sector. Also, it may force competition in the local economy. This may improve the efficiency of the allocation of domestic resources, reduce rents and the associated negative side effects for public governance, like for instance rent-seeking and corruption (Larrain and Tavares 2007). But FDI also brings its own challenges, especially for countries with weak governance and those heavily dependent on natural resource revenues. Without appropriate incentives, foreign investors might also contribute to the maintenance of bad governance and corruption, participate directly or indirectly to the `war economy` and the funding of armed civil conflicts and warlords.

While the literature recognizes the negative impact of bad domestic governance and corruption on FDI inflows (Wei (1997); Alesina & Weder (2002); Smarzynska and Wei (2001)), less work has investigated precisely the reverse relationship of the effect of FDI on host country governance structures. Two recent attempts however are Larrain and Tavares (2007) and Zhu (2007). The first paper discusses the two-way relationship between foreign direct investment and corruption, trying to identify exactly the direction of causality from “exogenous” variations in FDI on the degree of corruption in the host country. Using a dataset covering a wide group of countries for the period 1981 – 2000, the authors construct an original set of instrumental variables relying on geographical and cultural distance between FDI source and host countries to measure exogenous time-varying changes in FDI inflows. The paper finds that FDI inflows (as a share of GDP) significantly decrease corruption in the host country. The results are robust to the inclusion of several determinants of openness, in addition to trade intensity and the average tariff level, including dependence on natural resources, ethnic fractionalization, size of the economy and government expenditure.

Zhu (2007) extends this perspective by discussing how that the relationship between FDI and corruption is likely to depend on the level of development and the level of democracy of the host country. He suggests that in more democratic and developed countries, increasing FDI inflows are likely to contribute to reduction of corruption, while in non-democratic and less developed countries, a rise in FDI inflows may be associated with a higher level of corruption. To test these hypotheses, he uses a measure of FDI remoteness ⁷ as an instrumental variable to deal with the endogeneity of FDI on corruption. Controlling for other factors that the literature has found to affect corruption (ie; legal systems, religion, natural resources endowment, and ethnolinguistic fractionalization), the regression results provide empirical support for the fact that FDI inflows are likely to reduce corruption levels in more developed democracies, and increase corruption levels in less developed non-democratic countries. This type of results again a potential policy trade-off in terms of state building capacity and FDI openness policies. Building strong democratic institutions may be a necessary condition to capture the economic benefits associated with FDI .

This view is consistent with the more policy oriented perspective of Turner, Aginam and Popovski (2008) which recognizes the risks of FDI in weak institutional settings and emphasizes the fact that in the case of post-conflict countries, FDI openness needs some form of regulation that should be designed to prioritize quality of investment, rather than quantity.

Clearly an important implication for FDI to positively contribute to the local economy is the implementation of a legal and accounting framework in investors' home countries that encourage transparency and accountability. Solving this dilemma implies building a good investment climate and support for international initiatives to strengthen national and corporate governance, such as UN Convention Against Corruption (UNCAC) and the Extractive Industries Transparency Initiative (EITI).

⁷ FDI remoteness is defined as the geographical distance between host countries and the richest 20 economies in the world weighted by their real GDP per capita.

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