Aid in Conflict or Conflict in Aid

A Critical Analysis of the Role of Foreign Aid in Conflict Affected Countries

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1. Aid Effectiveness Debate Disputed[1]

The Conflict-Ridden Countries (CRCs) present a case where aid, if focused on short-term emergency assistance under a neo-liberal policy umbrella, will fail to have any beneficial long-term developmental impacts and might even lead to a worsening of the conflict situation. On the other hand, the CRCs also offer a potential case where a more comprehensive and careful understanding of the nature of conflict, the type of aid flows, and the nature of economic performance under conflict can shed light on the workings and allocation of foreign aid throughout the developing world. This highlights the continued existence, albeit different in nature, of the process of accumulation and development in a conflict country and offers an analysis of aid in that context.

The 'Aid Effectiveness Debate', as it came to be known in the latter part of the 1990s, constitutes a growing debate over the role of aid in economic development. The importance of the debate in policy-making circles is evident by the extent to which many of the aid projects undertaken by the International Financial Institutions (IFIs), notably the International Monetary Fund (IMF) and the World Bank (WB) have been based on the theoretical findings generated by this debate. This chapter will focus on the Aid Effectiveness Debate in its *current* format shaped by the works of Boone (94, 96) and Burnside and Dollar (97) which, for the reasons which will be discussed below, have shifted the debate to an entirely new level (compared to the previously-existing debat over aid), and has therefore constituted much of the current aid strategies for both bilateral and multilateral donors. This chapter will first provide a brief overview of the background to the current debate, before focusing critically on the core of the Debate originating from the works of Burnside and Dollar (97) [B&D]. Here the conceptual and methodological weaknesses of their work and their failure to take into account the case of the CRCs will be highlighted. The third section will review the literature generated in response to the above works, demonstrating that they, too, suffer from the same weaknesses as in B&D-type work, especially with reference to the study of aid effectiveness in CRCs.

We will therefore offer an alternative framework which conducts a political economy approach under a 'conflict economics' framework, as I would like to call it, which takes into account the specific context of any conflict and the institutional, political, social and economic impact that the conflict has on the structure of the country. These elements of conflict, it will therefore be argued, are not separable from the study of aid. As Anderson et al (1999) put it: 'When international assistance is given in context of violence, it becomes part of that context and thus also of the conflict'.

1. Background to the Debate over Aid

The past three decades have witnessed mounting criticism of the workings of aid in less developed countries (LDCs). After two decades of increasing IFI involvement in various developing countries, via adjustment programs and official development assistance, the latter countries still suffer from major macro- as well as microeconomic imbalances. In countries subject to largest IFI interventions, those of

[1] The term is from Hansen and Tarp, 2000 – although this does not mean conformity of our findings.

Sub-Saharan African and Latin America, economic and social indicators such as poverty and inequality are in sharp contrast to those in countries in East Asia where high rates of industrial growth were possible by distancing themselves from neoliberal policy prescriptions. By the end of 1990s, over 44 percent of the world's population were still unable to meet their survival needs, while 1.3 billion lived in absolute poverty (on or below 1 dollar a day) (Veltmeyer p125 [in Alfredo]). Mokhiber and Weismann (in Alfredo p125), surveying a sample of 89 developing countries, show that the growth rates of 79 percent of these countries have fallen by at least 5 percent by moving form a state-led development era (1960-80) to a market-oriented era (1980-2000). This decline in the socio-economic trends have mainly been attributed to the conditionalities attached to much of ODA which flows into these countries; hence the critics have viewed aid as a 'catalyst of underdevelopment and regression rather than of growth and development' which serves the political and economic interests of the donor community (Veltmeyerp125 [in Alfredo]). Aid as 'a form of imperialism' has once again made its way back into the literature in the wake of donor behaviour since the latter half of the 1990s (See Hayter for the early (1970s) analysis of aid as a tool of imperialism, and Veltmeyerp for later revival of the concept).

Although the nature of the criticism of the role of aid has changed over time, reflecting the ideological and methodological trends of the time, it has originated from the increasing disappointment and ambiguity with regards to the role of aid in economic development of the recipient country. These, combined with the decline of geopolitical significance of many recipient countries following the end of the Cold War, have resulted in a decline in the levels of aid disbursement in the 1990s, as a proportion of donors' assets (GNP, in the case of bilateral donors). The declining belief in aid as a contributor to development in the absence of other essential conditions has been strengthened, as Browne (99:ix) puts it, 'by the failure of much econometric and empirical research to find a clear correlation between aid flows and economic growth'. Below we briefly discuss how the debate over aid has evolved in the past three decades, leading to the creation of the *current* format, the so-called 'Aid Effectiveness Debate'.

In its early years, the 1960s, the effect of aid on growth was seen as a direct one where aid was only a lump-sum addition to the capital stock of the recipient economy, hence leading to higher investment and growth rates via its effects on savings. Much of these works were related to the Harrod-Domar model and the role of foreign capital in minimizing the savings gap in the economy. In this model the assumed excess supply of labour means that economic development is dependent on the levels of capital, the scarce factor of production. For example Rosenstein-Rodan (61) argued that 'Aid should continue not until a certain income level is reached in underdeveloped countries but only until those countries can mobilize a level of capital formation sufficient for self-sustaining growth'. This not only ignores the issue of aid dependency (see below) but also assumes that low investment levels in LDCs are due to lack of capital, hence not identifying the importance of the environment and the incentives surrounding the investors which prevents them from investing domestically.

At this stage, the Marginal Productivity of Capital (MPK) was assumed to be constant, leaving no room for the interaction of aid with other variables in the economy. This approach however came under criticism by Griffin (70), Griffin and Enos (70), Rahman (68) and Weiskopf (72) who argued that large foreign capital inflows may in fact have a negative impact on the levels of domestic savings by reducing the incentive to save, for both households and the government. Griffin argues that 'aid is essentially a substitute for savings'; it reduces the government savings by reducing its tax revenues or by changing the composition of its expenditure following the inflow of foreign aid. In addition the establishment of private foreign capital following the involvement of foreign donors can lead to a decline in profit rates of domestic investors and a reduction in their private saving rates. Foreign aid also stimulates the consumption of importables as the levels of foreign exchange rise following the inflow of aid.

A related issue is that of conditionalities attached to much of foreign aid flows and the related phenomenon of 'tied aid'. Tied aid is a phenomenon often use in relation to bilateral donors, where the donor ties its aid assistance to the purchase of capital goods and other supplies, such as foreign exchange requirements (imports), from the donor country, or that ties its aid to use in a certain sector only (Singer & Ansari, 161). In many cases, however, the conditionalities attached to much of multilateral lending can also be viewed in the same light: imposition of strict policy conditionality by the IMF which is biased towards supporting the IMF agenda, or the tying of many World Bank loans to the initiation of certain projects in the recipient country (regardless of the resource- and administrative-drains which might entail for the recipient) are also different forms of 'tied aid'. Even some contributors to the UN Development Programme make their assistance conditional upon the purchase of equipment or use of expert labour from the donor countries. Of course, it is practically difficult for a multilateral donor such as the World Bank to tie its aid to imports from any particular donor country, and hence the same function take place through project aid[2], for instance (Singer and Ansari). Yet as mentioned before, in much of the literature the two concepts of tied aid and conditionality are distinguished based on a narrower definition and depending on the type of donor.

Tied aid not only undermines the national sovereignty, but it also, and more importantly, undermines the local economy of the recipient country; putting them in a difficult situation where they have little choice as to the acceptance of such tyings. The recipient country cannot buy the most appropriate and cheapest product domestically or internationally. The issue of tied aid is also related to the increasing debt levels in the recipient countries. Import obligations imposed by the donors can lead the recipient to a situation of rising indebtedness, even where aid is given dominantly in the form of grants. In addition, if a bilateral aid inflow is bound to be spent on a small part of a large project (i.e. is tied to finance the imports of certain machinery from the donor), then it puts an extra financial burden on the recipient economy who is now required to fund the rest of the project by diverting resources from other sectors of the economy.

In response, other channels were highlight through which aid could benefit the economy; many empirical studies since the late 1960s showed that aid has an insignificant impact on saving rates, while having a positive impact on investment and growth (Hansen and Tarp 2000). The two-gap model developed by Chenery and Strout (1966) argued that a country will receive aid either because it suffers from the saving gap or the foreign exchange gap, and that the effect of foreign aid will differ *depending* on which gap is binding in that country. It was argued that it is the foreign exchange gap, rather than the saving gap, which can be effectively filled as a result of foreign aid, with positive impact on growth rates.

Until the early-1990s, the analysis of aid was focused on its direct effect on growth via the provision of foreign exchange and hence the much-needed investment that would follow. The direct link between aid and economic growth would imply a study of aid in isolation from other economic and political factors at work in the recipient or the donor country/agency. However, the increasing dominance of the neo-liberal economic approaches in the 1990s and the ambitious expansion of its analytical framework to the areas of governance and internal institution-building was reflected in the analysis of aid in the

[2] Project aid provides more specific earmarking of expenditure to a discrete set of activities for which coherent objectives and outputs and inputs required to achieve them can be defined. The donor-supported project can still be part of the government budget and can be subjected to policy conditions (Direct quote? Ref: *Mike Foster & Jennifer Leavy (2001)*.

context of development. The increasing obsession with restructuring of the economy according to vague concepts such as 'good governance' policies and practices was aimed at the larger goal of redefining the state-market relationship in line with neoliberal agenda: pushing for state policies which are conducive towards the long-term dominance of market forces and private economic actors in the economy. These changes in the policy-making circles opened 'a new chapter of conditionality', associated with internal political restructuring of the recipient country, attached to much of donor assistance following the end of the Cold War [Ref Doornbos]. Such direct involvement by the donors in the political and institutional structures of the recipient countries required a vague and broad enough conceptual framework which would justify their actions. The concept of 'good governance' provided such framework which not only allowed for a 'dramatic growth of financial institutions' at the expense of state involvement in development and welfare [Ref: Dumenil in Alfredo], but was also vague enough to be defined in different ways according to the preference of donors in any given recipient country. This became the framework for the donor-recipient relationship since the mid-1990s. Hence, since the mid-1990s, aid was no longer considered an isolated economic variable, but instead its workings was considered a function of the recipient country's economic policies. Although a desirable change of position from the outset, the attempt to expand the 'coverage' of their analysis has led to a heavily biased emphasis being placed on the role of the recipient country in enhancing the effectiveness of foreign aid[3]. This major shift implies that, whereas until now aid was seen as an absolute addition to the capital stock of the country leaving the MPK constant, now the MPK is no longer constant: it *changes* with the domestic policies of the *recipient* country's government. The next section is devoted to a thorough analysis of this new generation of debate, its origins, methodologies and weaknesses, especially with regards to the analysis of CRCs.

2. Aid Effectiveness Debate

The increasing discontent with the workings of aid both among the donors and the recipient countries' government, non-governmental and academic organizations, combined with a dissatisfaction with much of the previous analysis of the role of foreign aid, put pressure on the major donors, including the WB and the IMF as well as the United States, as the largest bilateral donor in the world, to justify their continued engagement in the developing countries. The outcome was a consensus put forward by these donors, in line with the Post-Washington Consensus, which blamed the 'governance' structures as well as the domestic fiscal, monetary and trade policies of the recipient countries ('currently popular indicators in empirical growth studies') for the failure of aid to achieve its developmental targets. The Post-Washington Consensus associated with Joseph Stiglitz's New Institutional Economics, shifted the focus from basic neoclassical concepts of competition and markets (which were the basis of the Washington consensus) towards the 'implication of market *failure*, the institutional setting of economic activity, or the potential outcome of the differences or changes in institutions' (Alfredo, 117, italics added). This implies that lower growth rate can be a result of ill-defined property rights, badly-regulated markets, or high levels of corruption and rent-seeking in the economy – variables which until then were not considered as having a direct link to the process of economic development. Institutional and governance reforms therefore became part of the requirements for and conditionalities attached to

[3] This bias has existed since the early years of aid analysis; for example Rosenstein-Rodan (61) argues that aid allows the 'transition from economic stagnation to self-sustaining economic growth'. However he goes on to argue that the principal element in this transition must be the effort that the citizens of the recipient country themselves make to bring it about'. Although similar in attributing the failure of aid to the recipient country, the later approach differs in that it directly attacks the internal social and institutional structure of the recipient country and making aid *conditional* upon a given package of institutional reforms.

much of multilateral and later bilateral lending since the mid-1990s. Whereas as late as 1971 Arthur Lewis announced that there cannot be any policy conditionality attached in foreign aid as it would infringe the sovereignty of the developing countries, already by the early 1990s a reversal in the relationship had happened: now, the state was depicted as the centre of corruption, rent-seeking and bad governance which is responsible for all the ills of developing economies (Singer, 95). The Bank now considered itself in possession of the secret formula of 'good governance', and used policy conditionality[4] 'to discipline the "bad boys", teach them a stern lesson and convert them into "good boys" (Singer, 95:3).

Although the 'two versions of neoliberalism', Washington and Post-Washington consensus suffer from the same methodological (associated with methodological individualism) and policy weaknesses, yet the latter provided a stage for a larger involvement of the multilateral financial institutions in the domestic economic and political affairs of many developing countries. The new consensus acknowledged that higher *levels* of aid are not sufficient for its effectiveness, instead what is required is a set of 'good' economic and political reforms in the recipient countries which ensure higher effectiveness of foreign aid.

This new debate over aid and foreign capital flows originates from the works of Peter Boone (94, 96) and Burnside and Dollar (97), focusing much of their work on the role of fungibility. Fungibility has been defined as a situation where the 'actual amount or the focus of any additional expenditure resulting from an aid inflow differs from that intended' [Ref: Beynon 2001]. The widespread use of the concept of fungibility goes back to the works of Singer. He relates the rise of the concept of fungibility to a drive within the World Bank, in the second half of the 1960s, to expand its activities and hence the budget it controls; Robert McNamara who became the president of the Bank in 1968 embarked on this task by seizing the concept of 'fungibility' which until then was dominantly known only in academic circles. Based on this concept, McNamara justified an expansion of the role of Bank from project lending towards more ambitious program lendings. He argued that, 'this doctrine [of fungibility] point[s] to a fallacy involved in project lending', and that is the release of some level of government budget resulted from aid inlfows can finance military expenditure and expansion of civil service wage bill; therefore, he argued, 'the WB's money would finance projects which it had not examined and which it was not even aware of' (in Singer 95, p2). This according to him, justified a larger, more flexible budget for the WB, with more monitoring power and involvement of the Bank in the recipient countries. Singer (& Ansari, p189), however, defines fungibility in terms an illusion, where the aid money can release some of the recipient's own budget to be spent on other, perhaps less important, projects. This as Singer argues can go into reverse when the partial and conditional financing of certain aid projects by aid donors requires the recipient country to actually divert its resources *away* from its other development projects. This notion of fungibility is related to the increase in project-tying by many donor agencies.

Boone, too, was among those who argued that aid has no effect on economic growth because it is often

[4] The IMF conditionality often refers to demand side of the economy, aimed at reducing inflationary pressure in the economy by cutting government expenditure, raising taxation, encouraging savings, limiting money supply, trade liberlaization and stable sustainable exchange rate. The WB conditionality is often concerned with increasing the supply side efficiency by using privatization, promotion of free markets and competition, promotion of investment and flexible labour markets (Singer, 95:5). Meeting the conditionalities of one of the two institutes will make access to funds from the *other* institute easier too – this is despite the fact that almost three quarters of the conditionality package are common among SAPs and stabilization programs (Singer 95:8). This 'cross conditionality' implies that in order to qualify for SAPs from the WB it is often required that country has accepted an IMF stabilization program. Adoption of these strict conditionalities is even sometimes (unofficially) vital for access to bilateral donor funding too.

consumed in an unproductive manner rather than being invested. However, there are doubts about the economic logic behind the concept of fungibility and whether it is a viable concept. There is also a large body of evidence showing that, assuming that fungibility is a possible outcome, evidence in favour of sectoral fungibility is very weak. McGillivray and Morrissey (2000) show there are a number of ways that donors can influence budget allocations and outturns, and hence reduce the levels of fungibility). Holmqvist (2000) also questions the reliability of many fungibility studies, whereas Cassen (86, 94) questions the significance of fungibility as an economic concept: he argues that there are limits to the phenomenon of fungibility when governments are clearly unable or unwilling to devote their own resources to specific activities. In addition, Mosely and Hudson (2001) show that the scope for fungibility has diminished in many developing countries as a result of a reduction in domestic funding for development budgets.

In what follows, however, we place a greater emphasis on analyzing the works of Burnside and Dollar (97) as theirs is a more advanced version of the analysis of Boone and is more closely linked to the main subject of this research, foreign aid flows. In addition, the B&D study has had a much greater effect on policy-making within the IFIs; it has constituted the theoretical backbone of much of the subsequent aid projects of the WB and the IMF.

Following the works of Boone which focused on the *interaction* between the workings of aid and the political regime of the recipient, the approach was further developed by B&D to include more direct measures of economic policy and institutional quality in the analysis of aid and economic growth. Unlike Boone’s conclusions that aid has no significant positive impact on growth, B&D expand and revisit his approach to show that the impact of aid is *conditional* on policy. There are, however, important methodological and conceptual weaknesses in this approach; such analysis also does not allow for a study of aid in countries undergoing conflict and war.

Burnside and Dollar (B&D henceforth) in their 1997 study, which was later republished in 2000 and 2004, embark on exploring the relationship between foreign aid and per capita Gross Domestic Product (GDP) growth. As mentioned above, their study was of great importance to the subsequent policy-making arena as well as forming, undoubtedly, the basis of the debate on aid effectiveness. They consider GDP to be an indicator of economic development, which is a dubious assumption, especially in the case of the CRCs where the nature of development changes and may not necessarily be reflected in the growth of domestic output. According to B&D, the ‘innovation’ in their work relates to the introduction of economic policies to the analysis of foreign aid. However this does not come as a ‘surprise’ to the social scientists and economists of the late-1990s familiar with the developments in economics discourse associated with the rise of neoliberalism. Rather than being a genuine step forward in understanding the workings of foreign aid, the B&D approach is little more than an integrated part of the inner logic of the current state of the discipline.

B&D argue that aid flows will provide the required capital in saving-constrained developing countries in the early stages of their development, hence enabling the return to their steady-state growth rate. This, in their analysis, will lead to their final catching up with the developed world. They go as far as arguing that in a ‘typical’ developing country, ‘an aid inflow equivalent to 15 percent of the country’s GDP will reduce the half-life to steady state from 42 to 35 years, while raising the GDP growth rate by 1 percentage point, causing a permanent upward shift in country’s GDP’. This has been compared with the case of a similar country but with distortionary taxes, where the return to steady state will only decline from 50 to 40, with the GDP growth rate increasing by around 0.6 percentage points (p7).

In their model, growth rates are a function of initial levels of income, institutional and policy distortions, aid and the interactive variable which captures the workings of aid in the context of certain policies. The mechanism through which aid affects growth is that of savings and investment, hence this mechanism does not hold only in the case of most developing countries, but also it is of particular irrelevance to the case of CRCs where the simple relationships between economic variables break down. In many of the CRCs, the neoclassical assumptions of perfect markets and perfect information which underlie the link between savings, investment and growth do not hold due to damage to and destruction of capital, labour and trade markets, break-down of the information channels between these markets as well as between different economic agents, further intensifying signaling problems. In addition, the nature and the duration of the conflict not only affects the nature and the levels of saving, it further weakens the relationship between savings and capital accumulation – the longer the duration of the conflict, the larger the damage to the investors' confidence.

B&D argue that based on 'recent empirical growth literature' [Ref: p19], a set of economic, political and institutional policies have been identified with significant impact on growth, and it is through these policies which aid influences growth. In their analysis, they look at four categories of policies: firstly, the institutional and political sets of policies, including secure property rights, efficiency of government bureaucracy, ethno-linguistic fractionalization, assassinations, the interaction between ethno-linguistic fractionalization and assassinations, and finally the levels of money supply as a proportion of GDP which is taken as an indicator of distortions in the financial system. There are, however, numerous difficulties involved in the choice of these variables. Security of property rights which is used based on the works of Knacker and Keefer (95) **[read]** are subject to fundamental criticism (Khan and Chang). In relation to most of the institutional variables, due to difficulties with data in this area, they *assume that these indicators change very slowly*, hence they use the figures for 1980. This is a particularly problematic assumption when it comes to the case of the CRCs, when the state is operating in abnormal circumstances, with its activities constrained by the forces of conflict. In addition, uncertainties involved in these conflict economies imply that indicators of political and institutional variables change *very quickly*. Assassinations and ethnic-linguistic fractionalization which are taken to indicate political instability, are inadequate measures: in many conflicts, ethnic, religious or linguistic differences are not necessarily a source of the conflict, and in addition the costs of conflict are manifested in a large number of different ways far beyond the number of assassinations per annum. The second category of policies included in the B&D analysis is the trade policies. Here they use dummy variables from the Sachs and Warner (95) openness index, defines an economy as open when it has average tariff on machinery and materials below 40 percent, or black market premium of less than 20 percent, or no government control of key tradable. These measures are, however, open to criticism (See Pritchett, Levine and Renelt). The third category of policies is monetary policy, for which they use the rate of inflation as a proxy (based on the work by Fischer, 93). The final category of policies involved in their study is that of fiscal policies, where budget surplus and low government expenditure are used to define 'good' policy.

John Weeks, et al, also criticize the foundation of much of the growth literature and the consequent literature on aid, poverty and development which has emerged out of these growth foundations. According to them, much of the policy implications issued by studies such as those of Dollar and Kraay and B&D, are based on a 'biased reading of the growth literature, including works from the World Bank itself'. The absence of concrete theoretical modeling in these studies provides will therefore provide a fertile ground for ideological inferences rather than genuine economic analysis to emerge (Ref?). The point that emerges from this and similar studies is that the growth regression used in B&D-type analysis are fragile, theoretically and empirically, hence a study of aid based on these equation, too, will be fragile.

They then interact this index with levels of aid flows and compare its effect on economic growth with separate effects of aid and policy. Their quantitative analysis is based on the following regression (1997:11):

$$g_{it} = \beta_{g0} + y_{it}\beta_{gy} + a_{it}\beta_{ga} + p'_{it}\beta_{gp} + a_{it}p'_{it}\,\beta_{gap} + x'_{it}\beta_{gx} + e^{g}_{it}$$

i country
t period

here the dependent variable is g_{it} which is the growth rate of per capita GDP of country *i* during period t. y_i is an independent variable, and an indicator of the initial level of real per capita GDP in that country. a_{it}, is the level of aid as a fraction of GDP (Aid/GDP)[5]. In their later works (B&D 2000), using a new World Bank database on foreign aid, they add the grant component of concessional loans to their previous measures of foreign aid. Their measure of aid is based on Fernandez-Arias and Serven (97) which includes grants and official concessional loans from both bilateral and multilateral donors. p'_{it} is an indicator of policy variables in the recipient country; this includes openness dummy as an indicator of trade policy based on Sachs and Warner (1995) index. This index which declares a country as open based on 5 (or 6?) criterion (including tariffs on machinery and materials above 40 percent and black market premium of over 20 percent) has been subject to much criticism in the literature **[Expand – main critics/critiques]**. Such measures used as indicators for openness, are not indicators of trade *policy* but rather measures of economic performance.

Their results do not apply to conflict countries specifically, not only because of the underlying assumptions behind their growth regressions and the policy variables used, but also their sample does not include a large number of conflict CRCs and assumes homogenous productivity of aid across countries **[expand]**. These issues will be explored in more detail in the next section where it will be illustrated how the B&D results alter as a result of inclusion of CRCs.

In order to account for the likely endogeneity of aid, and also to distinguish the effect of inclusion of different types of outliers, B&D also use the 2SLS model. Endogeneity would imply that there is a correlation between the aid variable and the error term in the growth regression; in other words, our equation suffers from omitted variable problem, which implies that the aid variable can be a function of a number of variables not included in the growth regression; these would include, for example, the level of population, the strategic interests of donors and the occurrence of negative shocks. Even when accounting for endogeneity, they argue that the earlier OLS results do not change; in addition it shows that the causality runs from policy to aid, in other words in means that 'donors reward good policy' (Ref?). B&D argue that although evidence shows that aid has not systematically affected policies during the period under study, when good policies have *coincided* with aid inflows, the outcome has been beneficial for growth rates **[direct quote?]**. But there are doubts as to whether this is a crucial conclusion, and one which contributes to the understanding of the workings of aid: it offers little in way of understanding why aid has *not* worked in most developing countries, especially the CRCs among them.

[5] They convert this from current US dollars to constant 1985 dollars using the unit-value of import price index from International Financial Statistics. They then report the figures as a proportion of real GDP in constant 1985 dollars.

3. Making of a Debate

Since 1997, based on the work of Burnside and Dollar (1997, 2000), as well as those of Collier and Dollar, the World Bank (WB) has spent more than a billion dollar a year, 5.4 percent of its total lending, on Public Sector Management reforms alone (Berg, 2000:291). These reforms are aimed at creating a 'good policy' environment (in the form of open trade policies and tight monetary and fiscal policies, as well as more 'democratic' government institutions), where aid can work more effectively. The 1998 WB report, *Assessing Aid*, argues, based on B&D conclusions, that a reallocation of current aid levels to LDCs with good policies will help an extra 18 million people per year to escape poverty; and therefore the absence of any significant achievement is blamed on the recipient governments and their inability and unwillingness to undertake the suggested reforms. However there is a sizable critique, in the literature, of the technical and conceptual aspects of the B&D-type analysis. This section shows that despite the importance of this body of critique, which has at places pointed out some major shortcomings in the B&D analysis, it has yet failed to highlight the specific inapplicability of the B&D framework to the case of the Conflict-Ridden Countries, some of the largest recipients of aid in the world. This is mainly due to the challenge that the study of conflict poses for the conventional economic framework, and it is this framework that even most critics fail to depart from. This challenge has, therefore, left a gap in the study of aid flows to these countries.

4. When Does Reality Lie?

As illustrated above, the recent literature on aid effectiveness forms a new and yet influential debate on the role of aid in economic development, one with wide implications for the policy-making of donors. However, as is evident by now, there are still major conceptual as well as methodological weaknesses in the current debate. Even the critics fail to depart from the neo-classical assumptions underlying the growth models used in most of these studies. This is not to dismiss the important role of some of these studies in identifying the weaknesses in B&D-type analysis; but the aim is to highlight the lack of more fundamental and innovative criticism of standard neo-liberal analysis of aid. Most critics fail to offer an alternative approach for the study of aid and confine their studies to quantitative analytical frameworks based on the same neoclassical assumptions. Below we list the major shortcomings in the main body of the aid effectiveness literature, especially with regards to the applicability of these studies to the study of aid in conflict countries. In section 5 we will then consider the importance of conflict and an overview of the current trends in the study of conflict and economic development. It will be argued that although challenging, an analysis of conflict is essential for understanding the workings of aid in a given country.

- ### Neo-classical foundations

One of the major underlying assumptions of B&D work, especially more pronounced in their later work (B&D, 2004), is that economic institutions and policies are the main determinants of long-term growth. This however proves to be a weak and unrealistic assumption when it comes to the case of CRCs, where the existence of well-functioning state institutions are important for economic performance but there are other factors, related to the forces of conflict, which dominate long-term growth prospects of the economy. Assumptions of competitive factor markets, perfect credit markets, no exogenous technical progress and constant population growth which underlie much of the literature both in the main body and its critics, also do not hold not only in the case of most developing countries, but especially are of great irrelevance in the case of CRCs where the functioning of markets are subject to substantial disruptions as a direct (e.g. physical destruction) or indirect (interruptions to the movement of labour and commodities) outcome of conflict. For example it is irrelevant to assume competitive factor markets in Palestine where exports and imports, as well as internal markets are subject to restrictive measures imposed by the Government of Israel (GoI) which reduces the competitiveness in these markets.

The current studies of aid are based on the neo-classical assumptions that the increasing returns to *capital* in developing countries imply that over time they will return to their 'steady state' growth path, and that they will 'catch up' with the developed world. The origins of the 'steady state growth path' which goes back to Schumpeter[6], developed for a one-sector neoclassical growth model (Jones and Scrimgeour, 2005, 'steady state growth theorem..'), defines the economy assumes a 'smoothly expanding economy' …. **[Original definition?]**. Aid is therefore considered as the mechanism for providing the needed capital in order to accelerate the return to that steady state. The notion of steady state is however subject to numerous criticisms, for example**.** The return to steady state, if such state actually exists, is subject to numerous variables and forces apart from capital levels *per se*. These include the nature of the terms of trade between the donor and recipient country (that is between the developed and the developing countries) and the value of economic and political environment which a country faces.

The main channels through which aid is supposed to affect economic growth are saving, investment and total factor productivity (TFP). However, as it is evident from most developing countries higher levels of capital inflow does not necessarily lead to higher levels of domestic saving; in addition, higher levels of savings do not necessarily translate into higher investment levels in the economy – this very much depends on the nature of classes whose savings has increased as a result of higher aid. Higher aid inflows may lead to higher public and private expenditure levels instead, as Griffin (70) and Griffin and Enos (70) have argued, higher levels of capital inflow can reduce the incentive to save domestically. In CRCs especially, where savings levels are distorted and the currency is at risk of sharp fluctuations, it is even more likely for aid inflows to go towards meeting high demands for financial liquidity. What determines the levels of investment is not the saving levels per se, hence other channels through which aid can affect investment need to be explored. In addition, incomplete information (which is the result of imperfect functioning of markets and the forces of conflict itself) and the problems of signaling will not allow for savings to be translated into higher levels of investment. Therefore the nature and duration of conflict can both directly and indirectly (through their impact on markets) affect the level and *nature* of domestic savings and breaks the link between savings and investment. The TFP channel is also not supported by most cross-country data (see Hansen and Tarp 2000).

The basic foundations of the growth regressions used in much of the literature not only ignore the existence of increasing returns to scale, but also assume free international mobility of capital and technology. The free movement of factors of production across countries is of course an unrealistic assumption with regards to the nature of economic relationship between the developed and developing world, with the latter increasingly restricting its outflow of skills and technology to the latter. Free movement of factors is especially an unrealistic assumption when it comes to the case of the CRCs: where as in the case of the WBG, the movement of capital, labour and technology is restricted even

[6] Formalized by Gustav Cassel and John von Neumann (Ref, also for Schumpeter: http://cepa.newschool.edu/het/essays/growth/aftermarx.htm)

within the territories themselves, let alone in relation to the outside world. Credit markets are also interrupted due to high levels of risk aversion, disruption in functioning of state's financial institutions and large scale control by the GoI of major sources of the PA's revenue, such as specific tax reimbursements.

The basic underlying assumption behind the use of growth regressions in these studies is that growth is the only mechanism through which aid can benefit the economy and reduce the poverty (based on earlier works by Krueger 'growth is good for the poor'). Little attention has been given to the role of aid in facilitating income distribution (See Beynon) which would require a different pattern of aid allocation than that currently being prescribed for the recipient countries. Such analysis which focuses on saving gap, as mentioned above, ignores the fact that in most developing countries it is not the lack of capital per se which causes poverty but the unwillingness of those with access to capital to invest their assets domestically. This is specially the case in CRCs where incentives are required in order to encourage investment by domestic capitalists in the face of challenging operational environment. This focus on poverty although justified on several grounds, poses the risk that the goal of development assistance might become a one-off reduction in poverty levels, rather than a longer-term assistance towards country's developmental path. This of course raises questions about the realistic objectives of development assistance and whether they are at all capable of contributing to economic development or that they are in fact only instruments for short-term adjustment and poverty reduction.

Much of the literature on the relationship between aid and economic growth lacks the support of theory, especially in choosing appropriate specifications for the econometric analysis. The choice of variables, and the functional form chosen are not based on concrete economic theories of economic development or theories concerning the role of foreign assistance. This problem is not only related to the founders of the 'Aid Effectiveness Debate' but also their critics. The major body of critics of B&D-type findings, criticizes their approach without departing from their neoclassical fundamentals which form the basis of the latter type studies; most critics still find themselves working with the same problematic growth regressions, data sources, neoclassical assumptions and broader frameworks used in the studies of B&D. These might be justified on the grounds that it shows fragility of B&D results even using their own methodology, but these will not be a useful exercise in line with a more fundamental analysis of the workings of foreign aid and economic development.

• How good is 'good policy'?

Good Governance

[Say something from Alfredo here on PWC and increase in governance discussions + then say a few lines from Mushtaq on governance and rent-seeking]. As Doornbos (?) notes, an interesting dimension of the 'good governance' agenda is that despite adding a political twist to the area of economic policy making, it calls for a *de*politicization of the political process. In other words, there is a paradox between the increasing focus on channeling aid towards government reforms, and at the same time aiming for a reduction in the role of the government (in line with the forces of globalization) in economic life of the country. This apparent contradiction can perhaps be explained by the new definition of the role of the government under the neoliberal agenda where reforms of the state institutions are not aimed at enhancing the role of government in the development process, but rather it is aimed at improving the state institutions so that they will provide a better institutional environment for the functioning of markets and the private sector.

The 'universality' attached by multilateral donors to good governance measures, not only has undermined the role of the state in the development process and the country's ownership of the development process, but also it has replaced country-specific policies with inconsistent and vague universal 'values' (Dornboos). As evident from much of the developing world, such as Africa and the Middle East, much of these reforms have failed to achieve their goals due to the already complex social and political contexts where they have been implemented. Dornboos argues for a restructuring of donor-recipient relationship, where the recipient would direct the process of aid (by demanding it when required) rather than being subject to pre-planned programmes, preferences and priorities of donors. With specific reference to conflict countries neo-liberal economics interprets the persistence of wars as a result of insufficient 'modernization' of society, therefore suggesting a set of reforms, such as commitment to structural adjustment programs, good governance reforms, reduction in corruption and rent-seeking, and other related reforms in order to increase the capacity for this style of modernization. Such modernization they argue, will reverse the 'mentality of collapse' which is closely related to the liberal definition of conflict. But this effort by the liberal camp to include the 'social' in their economic analysis (by inclusion of institutional and political analyses) suffers from lack of 'historical and relational content' with regards to conflict (Ref, Cramer in 'Anti-'). The current focus on institutional reform suffers from what Cramer calls an 'ideological gap' which makes it devoid of the historical content and specific balances of (national and global) class elements and political groups that in reality influence the functioning of such institutions and hence the economic performance in a given country (Cramer, Ineq).

Where conflict can be defined as a situation in which a significant proportion of the population is acutely vulnerable to death, disease and disruption of their livelihood over a prolonged period of time' (Suhrke and Woorward), the governance of such environments often becomes weak and challenged, resulting in a decline is state capacity to respond to economic challenges. It is in this context that one should analyse the applicability of 'good governance' in CRCs. Often in most developing countries, the state democratization remains an incomplete process where the state oppression or corruption does not vanish completely as a result of partial implementation of such reforms. This partial democratization and increase in transparency of the state institutions may in fact *increase* the risk of further conflict. Historical evidence shows that often authoritarian regimes are in a better position and more likely to implement adjustment programmes as they are capable of maintaining the adjustment policies in the face of resistance from those who lose as a result of such policies. Democratic governments, on the other hand, are often bound to the promises of transparency and are dependent on the electoral power of the voters, which implies that any adjustment programs will only get implemented half-heartedly as they might hurt certain sections of the electorates.

- **How significant is 'significant'?**

One distinct characteristic of much of quantitative works in the area of economic policy-making is the use of 'statistical significance' levels as indicators of *economic* relationships between variables. This has become such common practice that the distinction between 'economic' and 'statistical' significance has almost disappeared from most studies. McCloskey and Ziliak (in pack, p5) have shown that 82 percent of full length empirical studies which appeared in the American Economic Journal in the decade of 1990s, 'mistook statistically significant coefficients for economically significant coefficients'. This distinction is, however, crucial especially for policy-making purposes; a statistically significant relationship between two variables is an indicator of similar statistical trends in the two variables[7] [clear?], but says almost nothing about the actual economic relationship and causality between the two variables. The latter can only be determined with reference to theory and based on sound empirical evidence.

The 'significance levels' used in most studies to determine the importance of different variables in explaining the dependent variable have their origins not in sound economic theory, but are, instead, based on 'convenience'. Ronald Aylmer Fischer who established the use of significance levels and signifiance tests, stated that 'the value for which p = 0.05, or 1 in 20, is 1.96 or nearly 2; it is *convenient* to take this point as a limit in judging whether a deviation is to be considered significant or not. Deviations exceeding twice the standard deviation are *thus formally regarded as significant.'* (in McClotskey and Ziliak, in pack, p7. italics added.). Hence one needs to pay attention to the interpretation of 'statistically' significant relationships; as seen above, these relationships are based on arbitrary significance levels which have been chosen for the purpose of convenience and then have become formalized in economic analysis, and may therefore say little about the true economic and scientific importance, or even existence, of relationships between variables.

In addition, in much of the growth literature, the parameters of good policy variables reflect country averages and do not necessary apply to single country cases; as John Weeks et al argue (Direct Ref) 'what is true on average is not necessarily true for the components of an average'. Therefore one should take caution in interpreting the coefficients on policy variables.This is particularly important as in most of these studies the process of sample selection has been conducted on an *ad hoc* basis, with little attention given to whether the countries in the sample, in reality, belong to that particular sample of countries (see Levine and Renelt 91). As John Weeks et al argue 'Combining a large number of countries with stable policies, institutions, and politics with a small number racked by instability has the effect of averaging away the outcomes in the latter' (Ref?). With certain 'objective criteria' in mind one should 'separate out those countries that have undergone major policy change or conflict', and test this for distributional neutrality of growth, or any other economic analysis for that matter (Ref?). The interpretation of the relationship between policy and growth should therefore have its origins in concrete economic theory rather than statistical relationships alone.

- ## Where is the donor?

Like any other economic transaction, the business of aid also involves *two* parties, the donor *and* the recipient; hence the workings of aid is a reflection of the policies and workings of the *both* sides. However, surprisingly, there is very little analysis of the role of donors in the aid effectiveness debate. It is often assumed that universal aid projects of donors are appropriate in size and design, and hence any observed inefficiency of workings of aid should be addressed towards the recipient agent. Among the very few to consider the role of donors, is McGillivray et al who argue that donors need to make their aid programs simple and transparent to reduce the fungibility of aid. They argue that what has become known as fungibility of aid in conventional framework is rather an 'aid illusion': that is the differences in *processes* used by both the donor and the recipient for allocation and monitoring of aid expenditure and not a difference in *preferences* of both with regards to allocation of aid (as it is commonly argued). In many cases, government officials are not aware of the true budget constraints

[7] As Wallis and Roberts put it, statistical signifiance instead of implying practical signifiance, only signify 'a characteristic of the population from which the sample is drawn, regardless of whether the characteristic is [practically] important' (1956, p. 385 – in McCloskey et al, 96:101).

that they face following an aid inflow; this is because the conditionalities attached to many aid programs are not properly communicated to the local governments. This means that there is a role for donors to reduce the costs associated with aid transfer and to increase the transparency of their programs in order to increase the effectiveness of aid flows to any given country.

In addition, as studies by Harrigan et al show, the operation of major multilateral donors are constrained by the economic and political interests of their major western shareholders. An allocation of aid which is more in line with the interests of donors rather than the needs of the recipient country not only has less developmental effects, but it is also fundamentally flawed, undermining the notion of 'ownership' of aid programs. This is especially important when it comes to the case of CRCs where donor involvement in the situation of conflict adds a stronger political dimension to their aid assistance. In these situations aid is more likely to act as a strategic tool (in support of one party in the conflict) rather than an instrument of economic development. [See Nissanke, 1986, who shows that a model which assumes that all aid is aimed at serving donors' political, economic and trade interests has a much higher explanatory power in analysis of allocation of foreign aid, than a model which assumes that aid is given with the aim of compensating lack of domestic resources in developing countries].

Here the related issue of donor coordination arises which is especially important in conflict cases where due to the political nature of the situation, donors may have high stakes in involving in the conflict. This can lead to their large scale involvement via a large number of aid projects which can reduce the effectiveness of development assistance if there is not sufficient coordination between different donors and it can undermine the recipient country's economic performance by imposing demands on local governments to meet the demands and conditionalities of different types of donors involved. These are issues which we will come back to in future chapters. As well as the issue of coordination between donors, it is also important to put enough emphasis on the relationship between the donors and the recipient country, and their objectives and visions for the long-term development of the economy. In many cases, lack of overall agreement between the government and donor may be a reflection of good macroeconomic management of domestic actors which implies their unwillingness to allow policy intervention by the WB or the IMF. This is specially the case when aid comes in the form of general budget support which requires policy consensus between the government and central economic authorities. The absence of such consensus and the failure to recognize fundamental economic issues of the recipient country reduces the effectiveness of foreign aid even further. **[is this section on donor~recipient fine to stay in this section under coordination or should be moved elsewhere?]**

- ## External shocks

[Maybe have a summary of this at start of conflict section] Attempts to take account of 'external shocks' in the analysis of the workings of aid have not been developed sufficiently. Most studies such as Gulliaomont et al are limited to the study of climatic shocks. Although some have made a start on analysing the role of terms of trade shocks (see for example Collier and Dehn 2001), but these have again related this shock to climatic changes and in that sense differ from other more relevant approaches such as dependency theories or the effect of conflict on terms of trade. Such studies have however raised important questions over the fungibility of foreign aid; here a *poorer* allocation of domestic resources (due to shocks in the economy), the stronger the improvement in allocation of aid could be. However, apart from failing to depart from neoclassical methodologies of B&D-type analysis (they just insert an external shock variable to the B&D regression), they also have little policy implications for improving the workings of aid; they argue that a country subject to external (climatic or export price) shocks is a better target for aid but fail to comment on the key factors affecting the effectiveness of foreign aid flows.

- ## Growth vs. Development

Much of the work on the effectiveness of foreign aid focuses on the growth rate of Gross Domestic Product (GDP) as the indicator of the levels of development. Other measures of success used in the bulk of the literature include rate of inflation, the export and investment rates as a percentage of GNP **[correct way?]**. However a mere increase in the rate of GDP is not a sufficient indication of economic development; it says little of the actual developments in various sectors of the economy, of how the agriculture or the industrial sectors are growing, of whether the increase in growth rates are due to a real flourishing of the capitalist sector or a one-off increase in, for instance, oil revenues. Targets such as reduction of poverty, increased income-equality and employment, which are more closely to the notion of economic development and feature in the original mandate of the Bretton Woods institutions are often neglected in the analysis of economic outcomes of aid flows. Development in a long-term process of change, transition and restructuring which covers many areas of economic, social and political landscape of the country. In addition, an increase in growth rate says little about the beneficiaries of this growth, which would in turn determine the long-term potential development of the economy. The use of GDP growth rate as an indicator of economic development and as the channel through which the effect of aid on economy is being studied, is especially problematic in the case of conflict countries. Here development can take numerous forms, and economic growth, sustainability and development take new meanings which will not necessarily be reflected in a simple GDP growth rate (for a detailed discussion on this see section 5). Therefore when studying aid in a developing country, and more especially in a CRC, one should account for the *changes* in the nature and process of development, and to account for the various channels through which this development takes place. It will then become irrelevant to focus on a limited number of policies (that is fiscal, monetary and trade) as the main channels through which aid can effect economic growth. In addition, in the situation of conflict investment in some 'developmental' projects may not necessarily lead to increase in growth rates of per capita income nationally; for example, an expansion of water pipelines in a conflict-ridden district may not be reflected in the per capita GDP figures.

By focusing on *growth rates* one cannot draw implications for economic *development* of the country. Development is the eventual goal of economic transformation, whereas economic growth is an indicator of changes in the economy at each point in time compared to its previous points, however all these percentage changes together may *not* mount to the development of the economy. Hence this distinction is vital for defining the role of aid in the economy: whether it is destined towards a one-off increase in growth rates or is it expected to contribute towards the long-term economic development of the country – in the current thesis the focus is on the study of aid in view of long-term economic *development* of the recipient country. This focus also reinforces the belief that the process of development does not come to a halt in the situation of conflict, and that despite the many forces which work against this process, the bulk of economic activity and policy-making should still remain in line with the long-term economic development objectives of the host country.

- ## Aid Dependency

Diminishing returns to aid has been used as a justification for decline in effectiveness of foreign aid. It is argued that aid by increasing the size of the public sector over time, will have a limited positive impact on investment and growth. After reaching this limit, the inefficiency of large public sector prevents aid from having any further positive effect on growth expansion. The concept of diminishing returns to aid was put forward by economists such as Dalgaar and Hansen, and Lensink and White [mention a few more] as a departure form neoclassical framework where aid is assumed to raise growth indefinitely. However as it is evident, the underlying assumptions with regards to the size of the state are hardly a departure from the neoclassical stance on the issue of public sector. In addition, if one does accept that there are diminishing returns to aid defined in the above manner, the level at which these diminishing returns set in are very high and not many countries within the developing world have such high aid levels as a percentage of their GDP.

5. Bring in the Conflict

What emerges from the above is that the current framework for analysis of effectiveness of aid suffers from conceptual and methodological weaknesses which reduce its applicability to the study of aid in most LDCs and especially in CRCs. The relationship between good policy and growth has been proved fragile, yet the critics have failed to depart from the neoclassical framework – often only based on quantitative analysis – in order to offer an alternative framework for a comprehensive study of the workings of aid in different environments. The territories within which the current debate has taken shape are too fragile and limited for the study of aid in conflict; the study of conflict economies is a challenging exercise, far beyond the boundaries of neoclassical economics with its assumptions of 'universality' of economic processes. In what follows, four critical issues concerning the study of conflict are identified; a discussion of these issues is crucial for the future analysis of aid, or any other economic phenomenon for that matter in such contexts. A discussion of these themes will set the stage for a comprehensive 'conflict economics' approach, as I would like to call it, for the study of aid in CRCs.

5.1. Cost of Conflict

The overall impact of a conflict on a country's economic performance is a result of the *interaction* between the nature of the economy, the type of conflict that it faces, and the nature of the response given by the government and external actors in the fact of that conflict. Conflict can inflict numerous economic, social, infrastructural and political costs, and a comprehensive analysis of a conflict-economy should take these costs fully into account. Here a clear definition of the costs of conflict is important for categorizing conflict countries for the purpose of conducting economic analysis. What emerges from the literature on conflict and economic performance is that often the cost of conflict has been confined to its humanitarian costs – the number of battle-related deaths per annum. It is according to this criterion which conflicts have been classified in terms of their 'severity'. This is clearly an unsatisfactory measure of the cost of conflict, and one which does not represent its true extent and severity; hence failing to provide an appropriate framework for analysis of a given conflict. A more comprehensive account of socio-economic costs of conflict is needed in order to construct more informed policy conclusions. For example, HPG in their analysis of conflict define a protracted crisis as a situation where 'political instability interspersed with military conflict of greater or lesser frequency and intensity, is combined with socio-economic conditions that imperil the life and livelihood of a significant proportion of population – and where all these conditions are sustained over the long-run, at least several years' (Ref). Such definition is needed in order to construct a realistic framework for the study of the specific conflict at hand.

One should take into account these costs when analysing aid effectiveness in CRCs; as it will be shown in more detail in the next chapters, they are often these costs which pose the major barriers to the workings of aid in CRCs. Confining the definition of costs of conflict to the number of conflict-related deaths per annum[8] ignores those situations where the conflict is not of a nature that results in high death rates. For example, as Sarah Reinhart has demonstrated in the case of Palestine, the military policies of the Government of Israel are aimed at increasing the number of injuries rather than deaths in order to minimize the international pressure. Such injuries can result in disability and loss of life-time employment which leads to reduction in incomes and an increase in poverty, but also means a long-term loss to the Palestinian human capital, all of which needs to be taken into account in any analysis of the economic performance and labour market operations in WBG.

In addition, the use of different thresholds by different classification systems imply that in many cases conflict which are classified by one system as 'severe' or 'upper intermediate', are easily classified as intermediate by other systems. For instance, the Northern Ireland is excluded as a conflict country by the Correlates of War (COW) project which only recognizes 'war' in cases where there are more than 1,000 battle-related deaths in a year; while according to the Uppsala classification system, with its casualty threshold set at the much lower level of 25 battle-related deaths a year, Northern Ireland is classified as an 'intermediate conflict' (Cramer, forthcoming:12). A simple annual threshold level fails to say anything about the severity and intensity of conflicts across countries, as it does not take into account the total population of the conflict country. In other words, 1,000 battle-related deaths a year may constitute a much larger percentage of population in one country than another, hence such figure in its 'absolute' term says little about the intensity of the conflict and its effects on the local economy, while creating a flawed picture for the analysis of conflict trends across countries[9].

Two examples are worth mentioning here. First, the Greco-Turkish war in Cyprus (1963-64) which due to its 'low' number of fatal casualties has not been classified as 'war' in most classification systems. However, according to Sambanis, the roughly 2,000 deaths in that war represented 0.004 percent of the total Cypriot population – which is equivalent of 400,000 deaths in a country with a population of 100 million (in Cramer, forthcoming: 13). The second is the case of post-Intifada II in Palestine. During 2000-2002, 1,970 Palestinian were killed, which may just fall below the annual 1000-battle death threshold, and hence may not be classified as a conflict under certain classifications! However, the equivalent number of deaths for the United States would stand at more than 165,000; when comparing the numbers of injured in the same period (21,500 Palestinians), the equivalent numbers for the U.S. would stand at 1.8 million people (Ajluni, 2003:70)[10]. Therefore it is essential for the cost of conflict to be assessed relative to the demographic, social and economic structures of the country under question.

[8] Collier and Hoeffler for example, define a civil war as an 'internal conflict between the government and identifiable rebel organizations that result in 1,000 combat-related deaths [per annum], of which at least 5 percent is on each side'. [Ref? Direct?]

[9] Even the absolute numbers are, in many cases, difficult to trust, as access to data is made even harder in those countries where there is a conflict. This is due to both physical as well as political barriers which do not allow for a true estimate of the costs of the conflict to be represented. In many cases, the government of a warring country may not see it in their interest to report the actual numbers of deaths and casualties, hence deciding what needs to be reported rather than what is the reality.

[10] A further problem which arises here is whether to use 'battle-related' deaths or conflict-deaths. In many cases, the humanitarian costs of the conflict extend well beyond the number of those who die directly in combat. In many cases

Similarly, as Cramer (forthcoming) emphasizes, the distinction between different categories of conflict such as "civil war" and "inter-state war" are also important in the sense that they form the framework in which a conflict is analysed, and often 'shape *what* is viewed and *how* it is interpreted'. (p2, italics in original). Yet one should remember that classifications and categories are not 'natural' categories, but they are often artificially-constructed borders around a group of events which do not necessarily benefit their analyses. In other words, simplification of the analysis at hand should not be at the expense of ignoring the details of that unique case. As Cramer suggests, 'what matters is whether or not a set of categories hides more than it reveals'. (p11) 'the process of clarifying through classification systems and categorical distinctions necessarily involves simplifying the world… [T]his is not necessarily a bad thing. However, the simplification may be misleading. The simplification arises because the definitions involved works like borders separating artificially or at least crudely phenomena that might be rather closely related' (Cramer, forthcoming: 38).

The merits of grouping various civil wars in the same categories without any attention to the difference in their nature, origin, intensity, violence level, nature of actors involved, and the political and ideological aspects of the conflict, are questionable. As Suhrke and Woorward () argue, the economic damage of conflict should be analyzed in terms of its overall effect on country's economy. They criticize the works of Collier and Hoeffler (2000) for including India and Mozambique in the same sample of conflict countries: in the former, the conflict in Punjab has a much smaller effect on the entire Indian economy that in the case of Mozambique where the entire economy was devastated as a result of the conflict[11]. Failure to draw such distinctions, reduces the consistency and relevance of policy-prescriptions that follow. In assessing the costs of conflict one should look at the geographical spread of fighting, its duration, levels of displacement resulted, and the variations in GDP before and after the war.

One of the approaches to estimation of cost of conflict is the expanded version of the 'entitlement failure' approach: here, entitlement, defined as command over resources that permit people to have access to essential goods and services (Ref?), is subject to loss as a result of conflict. This entitlement loss can be in the following forms: market entitlement loss (loss of income and asset ownership as a result of conflict), direct entitlement loss (loss of basic goods and services such as food, water and health services), public entitlement loss (that is access to publicly available goods and services which are often lost as a result of reduction in state capacity during conflict), civic entitlement loss (those goods and services normally provided by the NGOs), and finally loss of extra-legal entitlements (which are often acquired through theft during non-conflict periods) (Ref, Stewart). Although criticized by Fine (Ref) for being 'neutral' with regards to social relations underlying such 'failures', an expansion of the notion of entitlement can offer one framework for studying different costs of conflict.

'military-caused' famine and diseases, rates of homicides which follow the 'end' of the war, the number of injured, psychologically-affected, and those tortured as Prisoners of War, all, need to be taken into account in order to assess the costs of a particular conflict, if a more realistic picture of the humanitarian cost of that conflict is to emerge. This is even not to say anything about those who have lost their means of livelihood, employment and income, and who, in many cases, have moved well below the poverty line.

[11] There are also other criticisms with regards to the works of Collier and Hoeffler; for example it is argued that their data and their conclusions with regards to the insignificance of grievance factors in explaining the risk of conflict, ignores the anti-colonial insurgencies of 1960s. It also ignored the patterns of distribution and inequality. In addition their proxies for 'greed' variable, especially the heavy reliance on primary commodity exports, have been questioned on the grounds that they might proxy for underdevelopment and hence grievance. (Pugh et al, p21)

Overall, what is essential here is a comprehensive estimation of the true cost of a given conflict in terms of its impact on economic activities, which needs to be fully taken into account for an analysis of economic performance under conflict. However, such estimation requires a comprehensive case-specific approach which the specific nature of the conflict at hand and the different channels through which it interacts with the conflict affected economy are carefully taken into account. This is a challenging task for the currently dominant frame of analysis of conflict economies, which confines itself to a surface-level study of economies and conflicts across countries. A true understanding of the economic costs of conflict is essential for a study of aid in such situations and for setting realistic expectations as to what international financial flows are capable of achieving in conflict economies. An estimation of humanitarian costs and the number of assassinations per annum is not anywhere near sufficient indicators of economic costs of conflict.

5.2. Economic Performance under Conflict

Much of the literature on economics of conflict and peace is concerned with the question, whether the *existence* of conflict or peace affects the growth rates of the economy. This, however, ignores the *mechanisms* through which a conflict affects economic performance and growth. Conflict countries are often treated as countries 'subject to exogenous development which takes them outside the normal realm of analysis' (Stewart). A large part of the literature on conflict is focused on the origins of conflict, it is often from such studies that conclusions about the workings of economy during the course of conflict are drawn. However, most of these studies focus on economic incentives as the main stimulants of conflict and ignore the relationship between the political power of those who benefit from persistence of conflict and those who actually carry its burden: Collier and Hoeffler (2000) admit that there are social, historical and geographical variables which also affect the risk of conflict *but* as these are assumed 'invariant' they focus on economic incentives in explaining the risk of conflict[12]. Such analysis which treats war as an essentially chaotic and irrational eruption of violence (Keen, pol eco of war) and looks at individual economic gains as the main stimulus to rebellions[13], ignores the true nature of most conflicts around the world where nationalist struggles, interstate wars of independence, 'grievances' of a section of the society and other factors – far from short-term economic benefit – form the origins of political upheavals and conflict. For example, in the case of Palestine, where the origins of conflict are routed in nationalist and anti-occupational struggles, much of the economic analysis based on 'greed-grievance' framework cannot be used to achieve a comprehensive economic analysis of the occupied territories. Since 1967, the imposed integrationist policies in the occupied territories have undermined the foundations of the Palestinian economy, leading to a *divergence* between the economic performance of Israel and Palestine. Such policies combined with expansion of Israeli settlements, closure policies, and loss of Palestinian control over much of their land and water supplies are grievances associated with anti-occupational tendencies which need to be addressed if any realistic picture of the situation is to be drawn.

As Cramer (Ineq, Dev) argues, the focus on greed variable is in line with quantitative nature of neoliberal economics which is a 'pursuit of closures, while the reality of lived political economy is

[12] Collier and Hoeffler (2004) argue for use of 'measurable variables' that enables a test between the two account of greed (opportunity) and grievance (motives), and show that the former has a stronger 'explaining power' in explaining the risk of conflict.

[13] According to Colleir and Hoeffler (2004), 'rebel groups often more than cover their costs during the conflict' (Ref?). Grossman also argues that conflict provides an 'atypical profit opportunity for rebellion', 'an industry that generates profit from looting, so that insurgents are not distinguished from bandits or pirates'. (Ref, quoted in above CH 2004).

social openness'[14]. This dominant approach to conflict is against the Marxist notion that 'social and ideational processes serve to obscure the proletariat's proper consciousness of oppression… [and instead argues that] it is the rebel supporters who have the false consciousness' (pugh et al, p22). These assumptions regarding the nature of conflict have led to the treatment of economic performance during conflict as a special and temporary phase which does not deserve a comprehensive economic analysis; this analysis can be conducted, it is argued, in the *post*-conflict situation when the irrational forces of conflict cease to exist. Understanding the nature of the conflict and the ideological forces behind its continuation are essential in order to construct a framework for the analysis of the economic performance under any given conflict, especially in case of prolonged crises.

It is important to acknowledge the ways in which economies are affected as a result of conflict and how this *changes* the behaviour and the role of economic agents including the state. The major changes in economic performance as a result of conflict come from destruction of capital, transport infrastructure, international markets, fragmentation or destruction of the labour-market, increased investment risk (and an increased liquidity preference), a reduction in foreign exchange reserves as a result of loss of export incomes, and an overall increase in transaction costs which damage the developmental process of the economy[15]. These are in addition to the micro and meso level economic difficulties. At the micro-level, the loss of entitlement can be observed on several grounds, as seen above. At the meso-level, the increasing government expenditure away from economic and social and towards conflict-related expenditures (with the resulted fiscal constraint, which is already triggered as a result of distortions to the tax system as a result of conflict), further intensifying the poverty levels as a result of reduced government social spending. The increase in non-tradable and subsistence productions, and the expansion of the informal sector are among the major economic changes. These changes at difference economic levels require new developmental approaches, increasing utilization of local capacities and 'emergence of new forms of social capital', led by firm government action (Stewart).

Most policy prescriptions by international agencies are based on inadequate understanding of the workings of the economy during conflict, therefore many of their policy recommendations result in outcomes which are contrary to the expectations of policy-makers. As Fitzgeral (Ref?) argues, currency devaluation requires high price-elasticity of import-demand and export-supply as well as downward adjustment of household consumption, whereas in a conflict situation with imports being largely debt-financed, devaluation will be passed entirely to domestic prices. In addition, export supplies are constrained by lack of investment and other military obstacles to exports, with the result that devaluation leads to a reduction in domestic demand. Reduction in government spending may reduce inflation, but this is at the cost of small producers who will suffer from credit reductions. The emphasis on a balance of payment, although desirable, poses the danger of assuming that macro imbalances are mainly monetary in nature when the behaviour of public and private sector are essentially different from peace times. Import liberalization at these times can ease the process of capital flights, and the focus on private investment is not sufficient to replace growth and uncertainty in the face of conflict and uncertainty. (Ref) As a whole the focus on 'market forces' becomes rather irrelevant during the time of conflict due to the disruption to the functioning of different markets such as labour, trade and

[14] 'Socio-economic outcomes spring from social relations rather than the aggression of individual reflexes. These relations are complex, and are influenced by history by the form that the development of capitalism takes and by exercise of and contest of power' – Cramer 'in Ineq'.

[15] According to Stewart, war not only destroys those sectors vital for development, but it also destroys the *organization* of social capital by weakening the government and worsening the infrastructure, and distorting the labour market. These also offer a challenging environment for the operation of aid agencies, hence their increasing focus on relief rather than developmental investments (Ref, Stewart).

foreign exchange, but also due to the existence of 'other forces' related to the conflict which form economic operation during those times. The pre-conflict relationships, market or otherwise, break down during the course of the conflict.

The breaking down of market mechanisms during conflict is in line with a redefinition of the role of the state in economic life of the country. During conflict the reduction in state capacity combined with the increased instability in the country can lead to diversion of some resources by the state to those groups who are considered a threat to state's survival and further instability of the country. This policy of containment by the state (which is not confined to conflict countries alone) can lead to an increase in activities of informal groups, sometimes from among militant groups. As Pugh and Cooper (War eco) argue, during the process of conflict one should account for the 'significance of alternative political economies in the margins of capitalism where the "norms" and "imperatives" of market economics are resisted or are beyond the institutional competence of state authorities to incorporate effectively'. These need to be viewed in the wider framework of the changes in the process of primitive accumulation as a result of conflict and war.

The distinctive and often 'brutal' nature of the process of primitive accumulation during war and conflict implies very difficult and risky working conditions underlying the process of capital accumulation (Pugh et al). In this situation the informal economy may benefit the process of accumulation and development in lines with what Mark Chingono described as being a 'barefoot economy' and a vibrant capitalism from below (in Pugh et al p65). Controllers of black markets and other informal and even shadow economies[16] may, given the right incentives and secure environment provided by a strong state, contribute indirectly and through unfamiliar mechanisms to this process via employment creation or provision of welfare structures and services which would benefit the neediest parts of the population – those left outside of the reach of international agencies. An across-the-board marginalization[17] of such informal groups can lead to a slow-down of the process of primitive accumulation during the course of conflict; This is specially important when the means of survival of the masses are frozen as a result of persisting social and political fragmentations and false peace deals, while the state remains weak and unable to protect the population in the face of both conflict and the pressure to implement market policies.

The increasing emphasize by multilateral donors on expanding the role of NGOs for delivering aid resources, has led to a decline in capacity and legitimacy of the state which is essential for preventing a total collapse of the economy and social order. There is a tendency, as part of the neoliberal agenda, to overemphasis the role of the civil society in solving to endemic problems of the developing world. For instance, it has been claimed that, 'empowered civil society institutions exercise good governance and are the vehicle to address gender equality, quality of education, employment creation, child protection among other issues defending the interest of the marginalized groups. These will advocate people's rights, delegate and rotate power.' (Rebab al mahdi 'what kind of civsoc donors want?' p17) This, however, ignores the fact many non-state entities face the same constraints and challenges that the state faces during the course of development especially when it is compounded with the forces of conflict, only that the state is often in a *better* position to face economic challenges and control structural inequalities that result in such situations as it has access to, what Rodrick calls, the 'institutions of

[16] The latter defined as those economic activities which are conducted outside state's regulatory framework and are not monitored by state institutions. (Pugh et al, p 9).

[17] This marginalization and 'criminalization' of informal groups are often pushed for by outside agencies; for example the case of Hamas in Palestine which has been declared as a terrorist organization by many Western donors and countries, while it provides essential services to large sections of the Palestinian population at a time of declining PA capacity.

conflict management' (Ref?).

The *apolitical* nature of NGOs approach, since the end of the Cold War, is a problematic issue when they operate in a conflict country. The emphasis on 'professionalization of NGOs' by the international donor community, has resulted in loss of autonomy, focus on short-term delievery goals, and the distancing of these NGOs from grassroots constituencies many of whom have been significant economic or political actors prior to the emergence of the latter. This professional NGOs, many of which are an outcome of the political motivations of donors, find themselves unable to establish 'horizontal links' with grassroots constituencies, as they ignore the 'political settlements' that underlie societies. This hinders the process of social capital generation required for genuine economic development and deepening of democratic forces which these non-governmental actors set as their objectives (Ref. Manal Jamal, in Palestine file on comp). Failure to undergo fundamental transformation implies that in an already-polarized political context of conflict, the continuing activities of NGOs can result in further marginalization of important social sectors, intensifying the underlying conflicts even further.

Hanafi and Tabar (2003) argue that NGO leaders 'often confuse between political and national', even in the case of many national NGOs (Ref). Whereas during the first Intifada Palestinian NGOs were a driving force behind the internationalization of the Palestinian cause, since the second Intifada they have only been 'spectators' and advocates of governance reforms. This is at a time that despite struggling to keep their 'external' political neutrality, most of them suffer from *internal* 'alliance-building and individualization of power and charismatic authority' (Ref). As they conclude, 'aid industry [has become] the conduit through which neo-liberal institutional arrangements arrive locally and affect NGOs' (Ref?). In addition, most conditionalities set by international donors are set with little regards to social needs of the population; counter-inflationary measures which can depress the purchasing power and economic growth in an already-weak economy; privatization which can bring benefits only as mall elite of entrepreneurs; and, deregulation which reduces the power the strong central government which is needed in order to maintain stability and lead the process of accumulation under conflict. The failure to acknowledge the changes in these roles of different economic agents as a result of conflict widens the division between a study of conflict and a comprehensive and careful economic analysis.

5.3 Conflict vs. Post-Conflict

One of the characteristics of much of the recent works on the role of aid in conflict situations are based on *post*-conflict situations. One of the most cited studies in the conflict literature, conducted by Collier and Hoeffler (2003), looks at the role of aid in post-conflict societies, with their conclusions being forcefully applied to situations where the conflict has not yet ended. This tendency to avoid the study of conflict situations is a constant theme associated with the tendency in neo-liberal economics to avoid analysis of economic situations and phenomenon which pose a challenge to its uniform analytical frameworks and assumptions. Conflict situations are often treated as temporary, hence being 'too exceptional' to deserve a separate frame of analysis. It is assumed that conflict implies a postponement of economic activities, an abnormal operation of institutions, and a halt to the process of capital accumulation, therefore any concrete economic analysis of the situation is postponed for '*post*-conflict'. The hesitance to deal with conflict situations is especially problematic in prolonged-conflict cases where the continuation of conflict means that lack of a comprehensive case-specific framework of economic analysis can have damaging effects for the policy-making and future development of the country.

A related problem is the definition of ‘post-conflict’. Following the signing of the Oslo Peace Accords, much of the economic analysis of Palestine treated the situation as post-conflict. However during this time, Israeli policies of closure expanded throughout the West Bank and the number of checkpoints increased steadily. The newly-created Palestinian National Authority was also struggling to establish its legitimacy. Yet much of the literature used the framework for the study of post-conflict to analyze the Palestinian economy; this framework assumes a once-and-for-all end to military incursions as well as re-instated economic, political and government institutions. These clearly do not apply to the case of post-Oslo Palestine, especially since the second Intifada II.

The political agreements and an international presence in the region which masks the true face of the ongoing conflict do not often imply an end to the conflict on the ground, and for a conflict to become *post*-conflict, an effective end to the conflict should be reflected in a definite end to offensive military strategies, economic improvements, political stability and enhanced livelihoods. As Suhrke and Woodward argue, for most people a decline in casualty figures signals an end to the conflict, whereas one needs to take into account the ‘institutional characteristics which mark the transition to a post-conflict situation’ (Ref?). Suhrke et al show that after re-coding samples of CRCs according to the latter criteria of post-conflict situation, aid shows up to 20 percent *less* effect on growth (Ref?). This distinction between conflict and post-conflict has implications for the activities of donor agencies and their attempt to ‘bring forward’ an arbitrary post-conflict situation which would justify their ‘neutral’ involvement in conflict situation. This distinction is also essential for identifying the radical differences in the potentials, objectives and workings of aid differ radically during the course of the conflict compared to the period after it ends.

5.4. Aid and Conflict

When aid is given in the context of conflict and violence, it becomes *part of* that context, hence its effect on conflict does not remain neutral – unlike what most donors like to propose. Aid can exacerbate the conflict if it is not well-targeted[18], but it can also reduce the local severity of conflict by strengthening local capacities. The approach to the study of aid in conflict has undergone transitions since their emergence in the 1980s. Initially following the criticism of the workings of aid and their impact on national capacities, the focus on emergency relief was justified on the grounds that it provides the ‘springboard’ for future development, hence aid actors were increasingly encouraged to adopt ‘developmental’ approaches to the study of aid in long-duration conflicts (HPG - direct Ref?)[19].

The tendency to combine a developmental approach to the analysis of aid implied that evolutions in the development discourse, now also manifest themselves in the aid debate. In addition, such marriage between the development discourse and emergency aid analysis was contradictory in nature as the former was aimed at *enhancing* state capacities while the latter was promised on state *failure* (direct

[18] This can happen because access to aid resources might be counted as economic or political power; or that in the case of Palestine, aid donors are often seen as agents which fulfill some of Israel’s tasks as the occupying power, hence assisting its presence inside the territories. Aid can also undermine peacetime production and productivity, by relying less on local producers and local capacities.
[19] There is no question as to the essentiality of relief and emergency programs, but the challenge is for donors to coordinate this with the longer-term objective of development and state capacity-building. In other words, it is not the question of lack of investment but rather the mis-investment which is often taking place by multilateral agencies.

quote, HPG). Therefore high levels of coordination were required in order to meet such objectives even partially. This led to a change in aid agenda in the 1990s where emergency relief once again dominated developmental types of assistance, leading to the dominance of import support in the form of food aid as the major form of aid assistance in CRCs. Such support has numerous advantages for the donors as it is not limited by absorptive capacity of the recipient country, needs almost no infrastructural or administrative investment, and can be initiated or suspended fairly quickly, making it ideal for donor conditionality (Fitzgerald in Stewart Ch2). However, in the recipient country, food aid has resulted in signal failures in its delivery to those most in need, it also has undermined local food production, and most importantly has not contributed to the economic development of the recipient country[20].

The new approach blames the ineffectiveness of aid on lack of political transformation and state reform while assuming the presence of well-functioning state institutions during the period of conflict. This concern with internal reform of the recipient country is in line with concerns with globalization and international security, developed by major IFIs, leading to a decline in the ownership of aid programs, raising more important questions among the critics, such as ‘according to which principle and under whose authority’ are decisions made by the IFIs? (HPG Ref) In addition, the increasing focus of the IFIs on *preventing* future conflicts is an indicator of their unwillingness, and inability, to deal with the challenging environment facing a country already engaged in conflict or war. Such challenges, as stated before, are beyond IFIs’ commitment to ‘universality of policy and uniformity of treatment’ (HPG Ref).

It is argued in much of the current debate, that the mechanism linking aid and conflict is growth rates. Colleir and Hoeffler (Conflict in global…) argue that aid leads to increased growth (based on B&D-type findings) and growth reduces the risk of conflict directly through growth effect and indirectly through the income effect. An increased risk of conflict here is based on the significance of the aid-policy interactive variable; but it is highly questionable how far an arbitrary significance level can form the basis of an analysis of a conflict and its origins. Even the critics of the mainstream analysis of conflict despite criticizing the link between aid, growth and risk of conflict, do not go beyond a ‘reform’ framework where it is argued that aid can only prevent further conflict if it is ‘part of a larger reform and institutional building’ which ensures that aid resources are not diverted towards parties with high stakes in continuation of conflict[21]. The analysis of aid in conflict situations is, therefore, focused on the role of aid in increasing or reducing the chances of a conflict-initiation, and the analysis does not extent to the role of aid once the conflict has started.

As Mark Duffield (in War eco) argues, an ideological mix of neoliberal concepts of democracy and market forces combined with current approaches to conflict resolution has given rise to contemporary strategies of intervention by external actors and donors (Ref in War eco). The ‘liberal peace’ paradigm[22] gives priority to ‘rule of law rather than social justice, to quick-fix elections rather than

[20] In addition, as Stewart (in Food Aid) argues, this leads to reduction in people’s coping mechanisms and a spread of disease as they move to crowded camps where food aid is distributed.
[21] This is related to the concept of ‘conflict trap’ (Ref?), often used for post-conflict situations, which argues that economic decline increases the risk of conflict (civil war, more specifically) and for post-conflict countries to reduce such risks, there is a need for improvement in governance and institution-building in order to benefit from aid-inflows and to strengthen the economic foundations of the economy in order to secure it against a reversion to a state of war. This has formed the basis of IFI policy-making with regards to conflict and post-conflict countries.
[22] Which is a related phenomenon to the increasing focus on security issues and their link with underdevelopment. The aim of the latter focus is a redefinition of conflict as an outcome of underdevelopment and lack of modernization, and the fear of global instability and insecurity which could be resulted from such underdevelopment can justify the presence of international actors in the conflict countries of the developing world. (See Pugh p196)

political accountability, to neoliberal economics rather than state direction to increase purchasing power, and to widening external influences rather than strengthening autonomy in the undeveloped world' (p6). Therefore what drives the intervention of multilateral agencies is not a genuine concern with economic performance of conflict countries and their future development prospects, but rather the broader dominance of neoliberal economics and its desire to monopolize the study of conflict with its limited range of analytical tools (see Ben Fine on eco imperialism).

What emerges is the need for a comprehensive analysis of the specific type of economy and conflict under study, and the nature and intentions behind the international involvement in such situations; it is the interaction between these *specifics* which determines the impact of international financial assistance to a conflict country. It is often believed that case studies do not 'inspire' theory and suffer from selection and omitted variable biases, endogeneity and measurement errors, but as Sambanis argues, these problems also exist in much of cross country quantitative studies and that well-designed case studies can in many cases reduce such problems by ignoring the unrealistic assumption of homogeneity which exists in most cross-country studies (Sambanis, Ref). In fact, it is through comprehensive case studies that by identifying potentially missing variables, the theory of conflict and aid can be refined and tested. A political economy approach starts from an analysis of economic agendas and social relations in a conflict-ridden country in order to arrive at a comprehensive framework of analysis, rather than taking a given orthodoxy or economic tradition as its starting point and then looking for a way to fit the case of any country to that standard framework. It is with this in mind that the rest of this thesis proceeds, adopting a political economy approach within a 'conflict economics' framework which acknowledges the importance of elements of conflict in reshaping the nature of economic performance and behaviour.