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DEALS AND DEVELOPMENT IN FRAGILE AND CONFLICT- AFFECTED STATES

Framework and policy guidebook



This framework utilizes business interests and the distribution of political power to understand the episodic nature of economic growth in fragile and conflict-affected states. Conflict, state capacity, and legitimacy are analysed alongside the business environment and structural transformation to explain when growth episodes arise and when those growth episodes have positive, or negative, feedback on the country's political economy and state fragility. The guidebook is designed to help advisers working with development agencies to analyse country context and design interventions with the goal of enabling positive growth episodes that reduce fragility.

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GLOSSARY

CLIENTELISM

A political system characterized by the provision of goods or services in exchange for political support.

CLOSED DEAL

A deal only made available to a particular entity based on their group identity, political connection, or affiliation.

DEALS SPACE

The business environment for firms as it pertains to their ability to secure licenses or permits, enforce contracts, or otherwise achieve investment-securing agreements, when such agreements are negotiated rather than rule-based.

DEAL

A specific negotiated agreement between two (or more) entities, one of which is normally the government. The specifics of the agreement are a result of the characteristics or actions of said entities, rather than as a result of an impersonal application of a rule.

DISORDERED DEAL

A deal that, once made, is likely to be honoured in the future only if it remains in the interests of both entities to continue abiding by it

ELITES/ELITE ACTORS

A small group of individuals who hold a disproportionate amount of political power or economic resources and thus exert greater influence.

FEEDBACK LOOP

A feature in a control system in which the output of the system is used as an input into future operations. In our context, a feedback loop takes an output of the country's growth record to help describe the evolution of future political and business interests. We characterize positive and negative feedback loops simply as those that have beneficial vs. harmful effects on future inclusive growth potential.

GROWTH EPISODE

A period without significant changes in a country's economic growth rate.

LEGITIMACY

Popular acceptance that a government has the rightful authority to govern and exercise coercive power.

MAGICIANS

Firms operating in industries that produce for a global market, in which profits are driven by product superiority or cost advantage.

OPEN DEAL

A deal available to any entity willing to agree to the terms.

ORDERED DEAL

A deal that, once made, is likely to be honoured even if financial interests or balances of power shift.

POLITICAL SETTLEMENT

The distribution of power across organizations including elites and social classes, which forms the basis for cooperation to govern.

POWERBROKERS

Firms operating in industries that produce for a domestic market, in which profits are driven by discretionary government actions such as licenses, contracts, and weak competition enforcement.

RENT SPACE

The distribution of economic activity, labour, and political access across the four quadrants of business types: magicians, powerbrokers, rentiers, and workhorses.

RENT

Profits in excess of what might be generated in normal, competitive markets.

RENTIERS

Firms operating in industries that produce for a global market, in which profits are driven by discretionary government actions such as favourable concession agreements, tax reductions, and weak monitoring.

RESOURCE RENTS

The profit that can be generated from extracting and selling natural resources above and beyond the normal profit that would accrue to a similar business activity in a competitive market; the rents will be at least partly due to the geological characteristics of the resource body.

STATE CAPACITY

The ability of a government to collect taxes, provide public goods, and otherwise accomplish policy goals.

STRUCTURAL TRANSFORMATION

The change from an agrarian, non-market economy to a market-based economy with increasingly diverse and productive activities.

WORKHORSES

Firms operating in industries that produce for a domestic market, in which profits are driven by product superiority or cost advantage.



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EXECUTIVE SUMMARY

The framework described in this guidebook is meant to be used by advisers working to achieve inclusive economic growth in fragile and conflict-affected states. The following pages describe the overall framework as well as each of the component variables. With each of the variables, we offer tools for further contextualization, key questions to ask, examples from fragile contexts, and possible interventions and risks.

Fragile and conflict-affected states experience volatile economic growth, with significant consequences for human welfare. Fragile states tend to grow in booms and busts, with little correlation with institutional quality or state capacity. Rather, growth emerges when businesses have a relatively stable environment for investment. Economic growth, if it is sustained and inclusive, can lead a country out of fragility.

The deals and development framework models the relationship between political economy variables (business and political interests), state fragility, and economic growth in the medium run. Different patterns of growth lead, through feedback loops, to adjustments in the political economy environment. The framework is designed to guide analysis and discussion rather than describe a specific set of interventions.

Business actors are categorized according to their demands of government. Some firms make profits by providing a superior product at a better price, while others depend on favourable government actions. Often benefiting from a captive domestic market, those protected businesses may provide the political finance that sustains government in a fragile state.

Some political settlements in fragile states are built around violence. When countries face armed non-state actors, a volatile combination of heavy-handed government response and divisive governance can emerge that discourages investments in basic state capacity. In such an environment, business opportunities are carefully allocated to select firms that can provide political finance rather than those that may lead to inclusive growth.

Firms in fragile states tend to face closed, disordered deals. Whereas 'rules' apply equally to all firms in the same position, 'deals' are specific to the firm or owner. Some deals are open – that is, available to all firms – while others are closed to those businesses without the right relationships with government. Ordered deals tend to be honoured once made, while disordered deals are more volatile.

Governments in fragile states tend to have weak incentives to invest in capacity to deliver essential services. Businesses that do not depend on educated workers or good infrastructure are unlikely to demand it, and political settlements based on repression or clientelism gain little from service provision.

Growth episodes that emerge in fragile states may have positive or negative feedback loops. When growth results from closed deals and declining investment in essential functions, it is likely to erode legitimacy and result in stalled or declining structural transformation. Such growth episodes strengthen economic and political actors that benefit from maintaining the status quo, which usually means continued fragility.

1 INTRODUCTION:

growth episodes matter for fragile and conflict-affected states

Most economic growth research, and corresponding policy advice, is based on the assumption of stable growth, but this only applies to Western OECD (Organisation for Economic Co-operation and Development) economies. Per capita GDP in these countries has tended to grow by close to 2 per cent per annum for approximately the past 150 years.¹ Economic growth research and policy has focused on the role of savings, investment, innovation, human capital, institutions, and other variables that can increase the steady-state growth rate.

However, most developing or emerging economies exhibit more erratic economic performance, reflecting a 'boom and bust' cycle. Nearly all lower- and middle-income countries have experienced neutral, positive, and negative periods of growth—including periods of rapid growth as well as collapse. These countries are poor not because they have failed to grow quickly, but rather because they have not been able to prevent negative growth.

A growth episode refers to the contiguous years which a country spends at a given growth rate. As it turns out, countries usually grow at a more or less constant rate for a period of time, from a couple of years to a couple of decades, before the rate of growth changes.² We refer to such periods of relatively constant growth as episodes. Growth episodes may be characterized by accelerating, maintained, or declining growth.

In fragile and conflict-affected states, growth episodes can be extremely volatile, with both economic collapse and rapid growth. It is tempting to label fragile states as being stuck in poverty traps. Indeed, when we categorize the world economies according to the level of fragility (see Table 1), the most fragile states have the lowest average growth rates, with many countries experiencing negative growth or stagnation. Yet that belies enormous variation across fragile states, with many growing rapidly. In fact, lulls or cessations in conflict can be a driver of rapid growth.³

Growth episodes have enormous consequences for human welfare in fragile states. When Indonesia emerged from intense fragility in the mid-1960s, it entered a 29-year rapid growth episode that would last until the 1997 Asian financial crisis, raising per capita income nearly four-fold. The gains in income from this growth acceleration, and the concomitant improvements in health and education, were astronomical.⁵ Economic growth is correlated with other measures of human development and provides the basis for meeting basic needs and aspirations as well as spending on public goods.

'Fixing' institutions will not necessarily translate into higher growth rates in fragile states. Influential research in the last two decades has emphasized the primacy of institutions in explaining economic performance.⁶ Yet while institutional quality does a good job of explaining long-run economic performance, institutions, unlike economic growth rates, are slow to change.⁷ Besides, changes in measures of institutional quality have almost no predictive power over economic performance in a broad sample of countries.⁸ We have also found that fast-growing and slow-growing fragile states have a nearly identical average score for public service quality, as measured in the Fragile States Index 2020.⁹

We thus need to better understand drivers of growth episodes in fragile states. If the usual explanations for growth in Western OECD economies are not applicable, and if fixing institutions may not have a measurable impact on economic growth in the short and medium run, then advisers in fragile states will need to understand how growth is triggered and sustained in fragile environments.

The stability of 'deals', which can be thought of as firm-specific investment policy, may drive a country's medium-run growth performance. Most low- and medium-income countries, and in particular fragile states, do not neutrally and evenly apply laws and regulations to all businesses and investments. Rather, there is a wide gulf between what firms are supposed to experience and what they actually do in such instances as receiving a construction permit, and there is wide variation across firms.¹⁰ Growth acceleration and maintenance seems to coincide with ordered, or stable, deals.¹¹

Table 1: Per capita GDP growth in 2018–19 by level of fragility ⁴

Quartile	Average growth	Standard deviation	Minimum	Maximum
Most fragile	-0.3%	7.0%	-36.4%	8.8%
2nd quartile	1.8%	2.3%	-4.9%	5.8%
3rd quartile	2.0%	2.6%	-4.5%	7.6%
Least fragile	1.4%	1.7%	-3.1%	5.0%



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2 DEALS AND DEVELOPMENT IN FRAGILE STATES: a guide to understanding the political economy of growth episodes

The framework outlined in *Deals and Development* is designed to analyse the political economy drivers of growth episodes. Published by Oxford University Press (OUP) in 2018, the book is available as a free, [open-access download on OUP's website](#).¹² It combines a framework with ten country case studies applying the framework; however, only one of these countries, Liberia, experienced extended conflict and extreme fragility.

Fragile and conflict-affected states exhibit unique political economy dynamics, but with a number of common symptoms. Fragility is a continuum, with many countries at all income levels, though particularly lower-income countries, exhibiting features of fragility. Experts have identified common symptoms of fragility that broadly are associated with conflict and/or low state capacity. An International Growth Centre (IGC) report¹³ highlighted six key symptoms:

- organized non-state violence
- government that lacks legitimacy
- weak state capacity for essential functions
- unattractive private investment climate
- little resilience to economic shocks
- deep societal divisions

In this guidebook, we have enhanced the framework to incorporate the key symptoms and drivers of state fragility. While the original published framework incorporated several of these key features, in this guidebook we are more deliberate in modelling these different symptoms and their relationships to one another and episodic growth inside the deals and development framework.

The framework application is intended to be analytically intensive, context-specific, and suitable for collaboration among advisers with different skill sets. To be sure, there is no easy fix to seemingly intractable challenges of promoting inclusive growth in many fragile environments. The deals and development framework is designed to be used as a framing mechanism rather than a pre-specified set of interventions. The framework can facilitate rich political economy analysis of the productive sector in fragile environments and its relationship with episodic growth and fragility. Relying on economics, governance, conflict and security analysis, and other specific expertise, the framework can be utilized as a tool of cross-pillar collaboration.

FIGURE 1: State fragility in the deals and development framework

2.1 The deals and development framework in fragile states

The fundamental aim of applying the deals and development framework to fragile and conflict-affected states is to help bring about positive and sustainable economic growth episodes that improve the underlying prospects for escaping fragility. Other frameworks for analysing fragile states or organizing foreign assistance in such places may be designed specifically for conflict resolution or state-building, and *Deals and Development* is not meant to supplant those tools. Rather, this framework seeks to consider the question of economic growth and its linkages with political variables including violence and state capacity.

The framework models the relationship between political economy variables (business and political interests), state fragility, and economic growth in the medium term (see Figure 1). Different patterns of growth lead, through feedback loops, to adjustments in the political economy environment. After a brief overlay of the framework, each of the component parts will be covered in more depth. For each component of the framework, key questions, examples, risks, and policy suggestions are laid out so as to guide analysts in their use and application of the framework.

The two core variables in the framework model the economic and political interests in a country and their interdependence. Economic interests are analysed in the *rent space*, which captures where the most profitable business opportunities

are in the economy and how different firms and sectors make different demands of the state. Political interests are modelled using the *political settlement* construct, which has been developed and used elsewhere.¹⁴ Societal divisions and non-state violence, symptoms of fragile states, are modelled within the political settlement.

These core variables drive the primary intermediate variables in the framework, which are the investment environment and the level of state capacity. The investment environment is captured through the *deals space*, which describes the nature of contracts and regulations faced by businesses. While the deals space focuses on the underpinnings of the market economy, the *state capacity* variable describes the level of investment in education, health, and physical infrastructure.

The intermediate variables, in turn, determine the nature of the growth episode and its feedback loops to the core variables – rent space and political settlement – in the framework. The rate of economic growth realized in a growth episode is only one component of the framework. In addition, based on the other variables in the model, a growth episode may affect state legitimacy and the pace of structural transformation. These dynamics, including the patterns of growth, then feed back to the rent space and political settlement – strengthening some interests and weakening others – which sets the stage for future growth episodes.

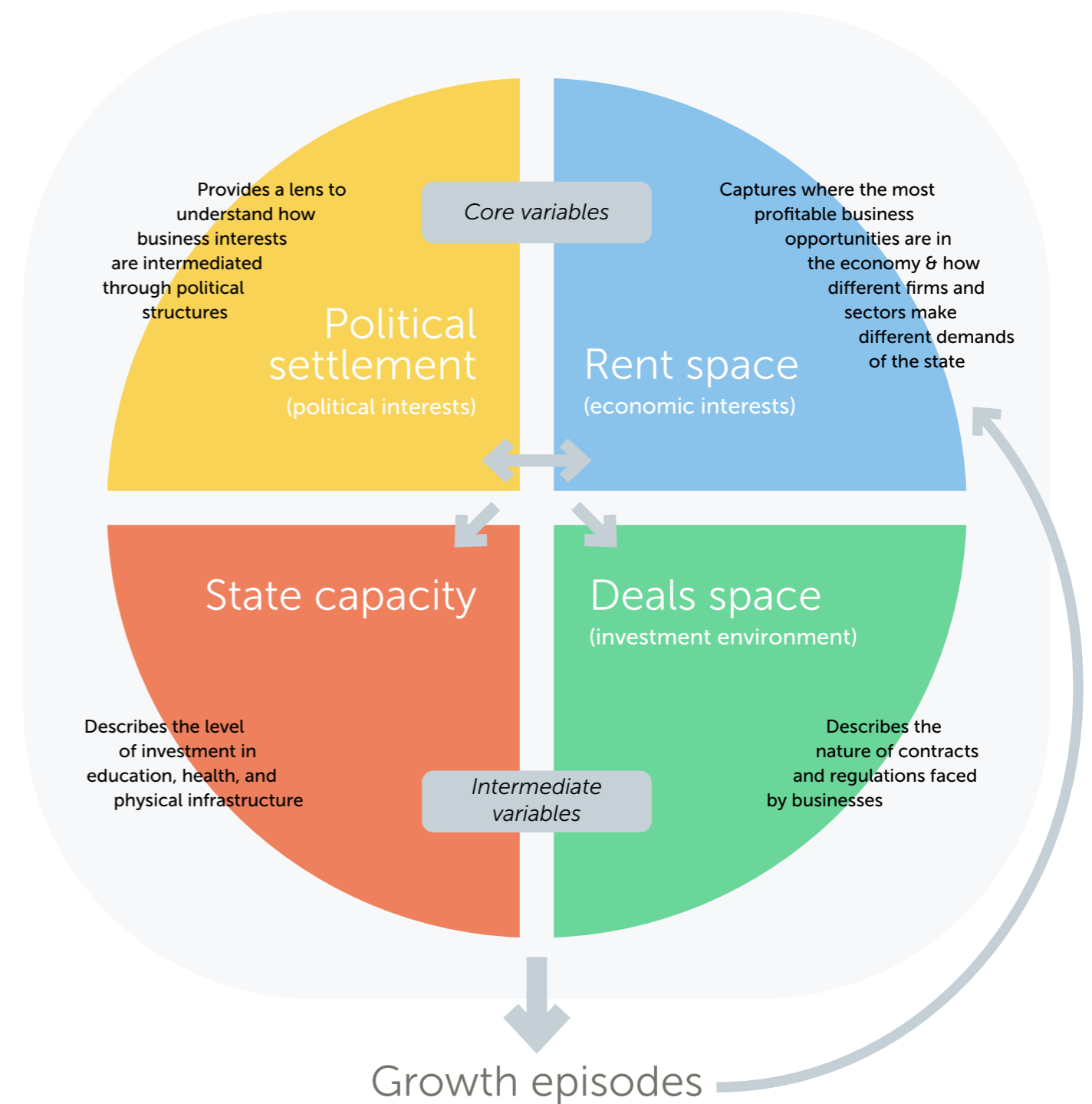
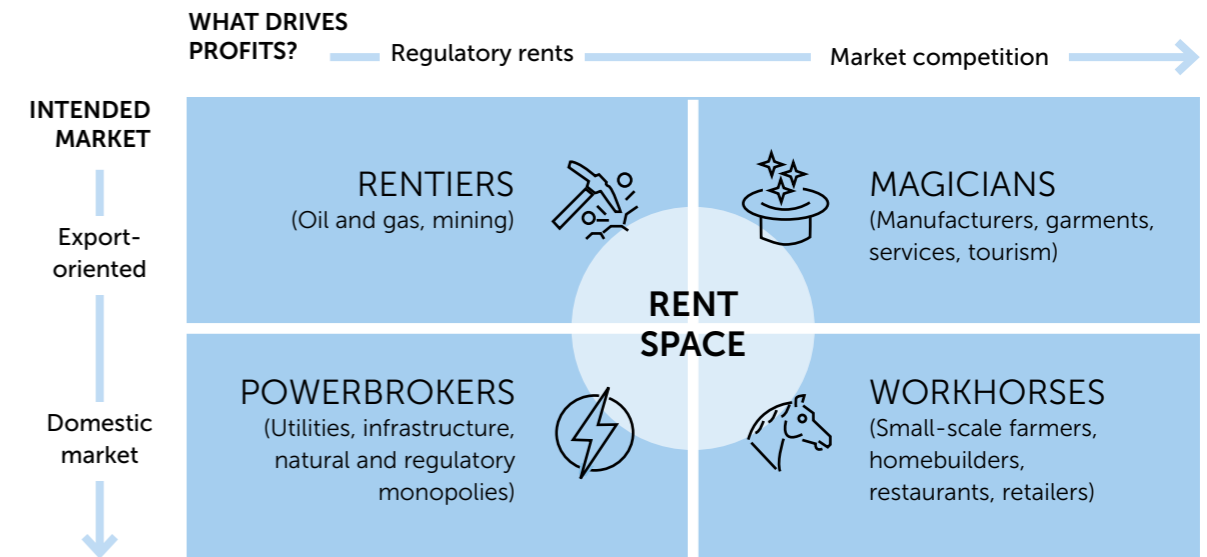




FIGURE 2: The rent space: a typology of firms¹⁹



2.2 The rent space

Research and policy frameworks on private sector development often give conflicting advice. Public choice perspectives argue that businesses seek to capture regulatory processes for their own benefit, thus implying that governments should protect themselves from business interests.¹⁵ On the other hand, business ‘cluster’ theories advance a more proactive role for government to listen to, organize, and attract business.¹⁶ The World Bank’s ‘Doing Business’ agenda advocates reducing the regulatory burden on firms,¹⁷ while efforts to increase government revenue to build state–society obligations recommend higher taxes on firms.¹⁸

The rent space simplifies the analysis of businesses by categorizing them based on what they seek from government. Part of the conflicting advice on private sector development stems from the fact that not all businesses are alike. Some firms benefit from a stable and consistent set of rules, while others thrive in an environment mired in red tape that deters entry and prevents outsiders from succeeding.

We divide businesses along two dimensions: the source of profitability and the intended market. Along one dimension, we consider whether profits are driven by market strategy (that is, firms compete on price or product characteristics) or non-market factors (usually government actions that regulate the industry or bestow benefits on specific firms). Within the other dimension, we consider whether firms sell to the domestic market or use factors from the country to produce and sell abroad. This generates four distinct groups of firms, which can be depicted in a 2 × 2 matrix: rentiers, magicians, powerbrokers, and workhorses (see Figure 2).

Each different business type has different demands of the state. *Workhorses* and *magicians* seek transparent rules, common infrastructure, and contract enforcement, while magicians additionally lobby for specialized infrastructure and trade preferences. *Powerbrokers* prefer exclusive arrangements and monopoly protection, and often thrive in murky enforcement environments in which their political access can be used to prevent new entrants. Rentiers often wish to be left alone to operate as an enclave, with ring-fenced governance and few interactions with other businesses.

Powerbroker and rentier firms are most likely to perpetuate state fragility. In many fragile contexts, magician firms would not be globally competitive given the costs of doing business. If the country is rich in natural resources, there may be opportunities for rentier firms to make excess profits that can be used to finance the political settlement. In any fragile context, particularly when foreign aid and remittances are the primary source of hard currency, powerbroker firms are likely to be a source of profitable business opportunities. When such firms are aligned with the state, they can provide finance in exchange for a business environment slanted in their favour. Industries with higher rents face slower growth, on average.²⁰

Key questions



- Estimate the share of the economy from each type of firm and map it onto the 2 x 2 matrix of the rent space. To do this, use expert judgement on the source of profits against

a country's value added using industry GDP statistics and export statistics (recognizing that exports are final sales, not value added).

- Are the majority of people working in any one part of the rent space? Does that match where those businesses with political influence are based?
- How organized are producer interests in each quadrant? Which of these interests advocate for reforms that might lead to inclusive growth? What might key firms presently benefiting from state fragility need to shift their behaviour?
- How close are the links between powerbrokers/rentiers and political elites?

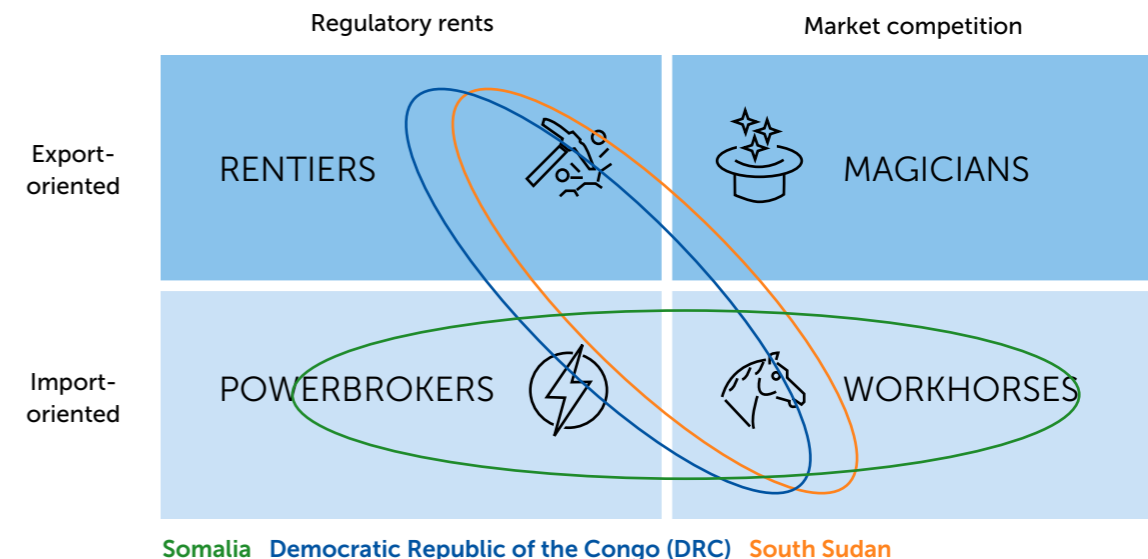


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Example: Somalia

Somalia's workforce engages largely in workhorse industries, from raising livestock to subsistence agriculture and petty trading. In contrast, Somalia's larger and more politically connected businesses are in protected powerbroker sectors, including telecoms, banking, and real estate. Clan and religious affiliations, along with personal networks, determine firms' ability to access regulatory rents: for instance, telecoms access at the local level is determined by these affiliations. Somalia's limited natural resources mean that opportunities for rent creation are mostly limited to domestic-facing businesses. The resulting oligopolies have created a stable set of business interests that thrive in the presence of a weak state with limited export opportunity.

FIGURE 3: Mapping the rent space in the three case study countries²¹



Possible interventions

- Sector development activities in workhorse and magician industries to create new constituencies favouring inclusive reforms
- Consumer-focused efforts to provide incentives that promote competition or limit monopoly pricing in powerbroker sectors, particularly those that improve competitiveness of magician firms through reduced input costs
- Value chain development supporting workhorse firms to supply rentier projects and government/aid procurement
- Encouraging powerbroker firms to begin domestic production of new, more productive, and competitive products or services



Potential risks



- Laudable efforts to 'listen to the private sector' may only draw audiences of powerbrokers and rentiers, who depend on government action for profits; make sure workhorse and magician firms represented
- Supporting individual firms with productivity-enhancing interventions may lead to market power rather than growth; be aware of a target firm's interests
- Workhorse industries might prefer to be powerbrokers and do not always lobby in the general interest; separate individual from collective benefits

Further reading

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2.3 The political settlement



group's relative prominence in the settlement will reflect its underlying power.²⁴ That said, coalitions can shift, particularly following elections, coups, or conflict, resulting in changes to the composition of elite actors.

According to Khan, political settlements can be usefully characterized along lines of both vertical and horizontal power.²⁵ Horizontal power is the distribution of power among rival groups jockeying for control; vertical power is the distribution between elites and non-elites. More competitive political settlements are those in which horizontal and vertical power is dispersed.

Fragile states are more likely to suffer consequences from societal divisions,²⁶ which will be reflected in a less stable political settlement. Such political settlements may be characterized by active competition for power, reducing the stability of the settlement. Deep societal divisions along either dimension make it harder for stable political settlements to emerge.²⁷

In conflict-affected states, stable and unstable political settlements may emerge in which violence or the threat of violence plays a role in sustaining the settlement.²⁸ De Waal describes a 'political marketplace' outcome in the Horn of Africa in which political actors seek financial pay-offs in proportion to their ability to control and disrupt through violent activity.²⁹ In other states, warlords or insurgents may engage in violence, business licensing, and trade to sustain political power. In still others, violent actions by non-state actors may help to sustain an incumbent political settlement through targeted exclusion and repression.³⁰

Political settlements theory relates how political elites manage and underpin the exercise of power and governance in a jurisdiction. The concept has been utilized in policy-making and advising, including in fragile states, since around 2007.²² Di John and Putzel define it, summarizing Khan, as 'the balance or distribution of power between contending social groups and social classes, on which any state is based'.²³

The political settlement provides a lens through which to understand how business interests are intermediated through political structures. While business interests are often stable, as they reflect the underlying economic opportunities in a country, the same business elite may face new government policy and investment decisions when the political settlement changes.

Different coalitions of elite actors may be able to sustain a political settlement, resulting in significant potential movements in political interests. A political settlement must be able to sufficiently reward insiders and protect against outsiders to remain stable. Often an actor's or

Key questions



- What forms the basis of elite co-operation in politics? How are the business interests of those in each quadrant of the rent space incorporated in the political settlement, if at all?
- How stable has the political settlement been historically? How stable is it now?
- How inclusive is the settlement in terms of both vertical and horizontal power? Which elite and non-elite groups that have underlying power are excluded from the settlement?
- What are the interests of different political elites in fostering, or constraining, inclusive growth?
- What role does violence play in the political settlement?

Example: Democratic Republic of the Congo (DRC)

Joseph Kabila served as president of the DRC from 2001 to 2019. Leading a kleptocratic government that ruled from Kinshasa, Kabila monetized the country's vast hydrocarbon and mineral reserves for personal gain and the maintenance of power as the head of a patronage-based government. Despite DRC's vast population, the spoils are shared with a narrow group. The wide geographic dispersion of the population and of mineral deposits results in powerful local elites.³¹ Conflict in the east permits the government to use the army as a form of patronage, sustaining a 'military bourgeoisie' with an interest in continued violence.³² Low salaries for government employees and irregular payment of civil servants sustains corruption and weak service delivery.

Possible interventions

- Interventions to increase inclusion, representation, and political participation of marginalized groups
- Strategic appointments and technical assistance to reformers
- Conflict resolution and power-sharing activities
- Identification of alternative foundational bargains to the status quo, which might permit more inclusive growth



Potential risks



- Foreign assistance and peace-building can inadvertently consolidate a political settlement by strengthening the incumbent regime and institutions³³
- Peace agreements may provide the political finance to sustain settlements underpinned by the threat of violence³⁴
- Externally imposed elections may generate a veneer of inclusion without fundamentally changing the political settlement³⁵

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 Effective States and Inclusive Development: effective-states.org
 Anti-Corruption Evidence Consortium: ace.soas.ac.uk

2.4 The deals space

Firms in fragile states face deals, not rules. A *rule* is when laws and regulations are neutrally applied to all businesses irrespective of the identity of the business or the timing of the situation. However, there is a large gap between the rules on the books and the actual experience of firms in lower-income countries.³⁶ In contrast, a *deal* is a firm- or individual-specific arrangement with no precedential value to future transaction between other entities.³⁷

The deals space describes the types and stability of deals faced by economic actors. These deals create the basis for investment or contract stability, or the lack thereof. The particularities of the deals space are based on the interests of the actors in the political settlement, and are driven in part by the demands of politically connected firms in the rent space for firm-specific government oversight or action (see Table 3).

Deals may be open or closed. *Open deals* are available to all investors, large or small, whereas closed deals are offered by the political elite to only a small group of favoured investors. Open deals are distinguished from rules in that they may have little or nothing to do with existing regulations; in Mozambique, for example, realized fees (deals) often vary from official fees (rules), and any firm can simply hire a private agent to get their shipments through (open deals).³⁸ Closed

deals tend to be available to politically connected investors; in Charles Taylor's Liberia, forestry concessions were made available to businessmen who financed elections and brought in arms.³⁹

Not all deals are equally reliable. *Ordered deals*, once negotiated between investors and state officials, are honoured. In contrast, *disordered deals* have little certainty and depend on the underlying logic of the original deal to remain in place. In some countries, the deals space can change quickly depending on the political regime, and deals that may have been negotiated (and ordered) under one political settlement for years or decades may be suddenly dishonoured.

Fragile states tend to have closed, disordered deals. The deals space in fragile states is usually closed, given the precarity of the settlement, which necessitates a greater dependence on clientelism. This in turn requires a greater reliance on crony business relationships, the very essence of closed deals.⁴⁰ Deals are also likely to be disordered in fragile states, particularly as the political principals who make them rise and fall from power and their successors make new deals.

TABLE 3: The deals space⁴¹

	Closed (Deals are available only to specific individuals/organizations)	Open (Deals depend on actions of agents but not identities)
Ordered (Once negotiated, deals will be honoured)	Only those with political connections get to make deals, but they can be confident that officials will deliver	Anyone can make a deal, and they can be certain that officials will deliver
Disordered (Deals will be houloured so long as they are in the short-term interests of political elite)	Only those with political connections gey to make dealsm and even they cannot be certain that officials will deliver	Anyone can make a deal, but no one is certain that officials will deliver

Key questions



- For each quadrant of the rent space, are deals open or closed? Ordered or disordered?
- How are closed deals allocated, and what is the political function of the closed deals space?
- How are deals between private actors enforced? Can they rely on contracts and commercial courts?

Example: South Sudan

Most deals in South Sudan, even the larger ones, are closed and disordered. A weak legal system provides little recourse for firms to challenge dishonoured agreements. In the rentier quadrant, oil companies only get 4–10-year licences. To retain political value, oil companies are pressured to award lucrative contracts to favoured companies at inflated prices. In the powerbroker quadrant, the largest telecoms company left after its deal was reopened in 2018. Some disorder is the result of jockeying among elites. Workhorses face an open and disordered environment that is mostly neglected by elites given the marginal profitability. Open, ordered deals are present in contracts from international non-governmental organizations (NGOs) and aid organizations, but the practice is not dispersing throughout the wider economy.

Possible interventions

- Micro-climate interventions to open the deals environment in particular industries
- Getting the 'big deals' that provide government finance and other business opportunities right, so as to maximize benefits to the right constituencies
- Supporting policy shifts that affect investor expectations
- Transparency efforts around key contracts, and support to civil society or research organizations capable of explaining them to the public⁴²



Potential risks

- Making business regulations more investor-friendly and moving up the Doing Business rankings may have little impact if rules are not enforced
- Complex regulations to avoid corruption may lead to closed deals emerging elsewhere
- Focusing exclusively on government-business deals environment may result in neglecting contract stability within the private sector



Further reading

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2.5 State capacity

Fragile states commonly have low state capacity for essential functions. The IGC *Escaping the Fragility Trap* report describes this as a ‘failure of delivery of basic services to citizens and firms, such as infrastructure, education, or healthcare’.⁴³ State capacity can be thought of as one aspect of a country’s institutions, which broadly correlate with economic development; in the World Bank’s governance indicators, for example, ‘government effectiveness’ captures a broader measure of state capacity that includes public services, civil service, and policy formation.⁴⁴

State capacity is a ‘stock’ variable that can move only gradually through investments or neglect. In contrast to ‘flow’ variables like miles of new road built, ‘stock’ variables like the total road network reflect a long history of influences. At present rates of change, it may take decades or centuries for some fragile states to catch up with low middle-income or high-income countries in measured capabilities.⁴⁵ At the same time, when neglected

(but not abandoned), state capacity does not disappear overnight: infrastructure, education levels, and healthcare facilities depreciate from their prior base.

Investment in state capacity for essential functions can be thought of as investment in the physical and human capital that is crucial for economic growth. Infrastructure offers some of the physical capital of the economy, while health and education contribute to human capital. While the deals space covers the stability and breadth of business contracts offered by government, state capacity for essential functions relates to the productivity of inputs (as facilitated by government) that may be behind any given investment.

In the framework, low levels of investment in state capacity are driven by political logic rather than inherent ability. Many commentators disappointed by slow government reforms in fragile states decry ‘low capacity’, but in our view, capacity is usually anything but low; it is just not directed towards reform. Rather, when elite actors do not see a return in investing in basic services, it is less likely to occur.

Fragile states are less likely to have political logic for investing in state capacity for essential functions.⁴⁶ Business interests, including powerbrokers and rentiers, may not require common infrastructure or human capital to make money. A political settlement bolstered through repression rather than legitimacy will similarly not prioritize investment in state capacity.



Key questions



- What role does the state currently play in providing essential services? Are there other actors providing essential services?
- Are investments in basic state functions going in the right direction? What about investments in other modalities of providing essential services?
- To what degree are citizen preferences for essential services realized in government action? Is government behaviour eroding the legitimacy of the state or strengthening non-state actors?
- Is government policy sophistication proceeding at the same rate as its underlying ability to deliver?

Example: Liberia⁴⁷

Never a beacon of state capacity, Liberia nonetheless had functioning schools, roads, and hospitals at the time of the coup d’état in 1980. Liberia’s narrow political elite centred around the capital, Monrovia (which was also the location of most of the country’s modern infrastructure), and its sons and daughters for the most part attended parochial schools. Patronage fuelled by resource rents, combined with the systematic exclusion of the majority of the country’s population from political power, drove the political settlement, so there were limited incentives to invest in state capacity. As the country entered an improvised military government followed by civil war, GDP declined precipitously. Infrastructure was neglected and then looted for the scrap value. Civil servants, including teachers and professors, became compensated increasingly through bribes, distorting the provision of essential public services. Transitional governments intended to establish a non-violent political settlement were more concerned with dividing the spoils than re-establishing basic services.

Possible interventions

- Direct support to on-budget, inclusive, and transparently financed government efforts to better provide basic state functions
- Encouraging policy development that promotes improvements to state capacity while being realistic to implement
- Supporting promising ‘pockets of effectiveness’ with principled and talented policy-makers in narrow areas⁴⁸
- Engaging with civil society organizations that seek to increase the responsiveness of government to citizen demands for state capacity



Potential risks



- Over-investing in a hollow state without access to sufficient tax revenue and legitimacy risks creating an unfunded liability
- Providing essential services directly risks undermining government capacity development⁴⁹
- Designing new policies and laws ahead of implementation ability risks undermining state-building by eroding legitimacy
- Providing ‘capacity-building’ to individual bureaucrats often wrongly assumes that their lack of individual capacity is the problem

Further reading

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2.6 Growth episodes and feedback loops

Growth episodes are determined primarily by the deals space. In our research, we found that accelerations in growth occur with a switch from disordered to ordered deals. Growth maintenance is facilitated by open ordered deals. In fragile states, essential state capacity does not appear strongly correlated with growth, which means that growth can occur despite low state capacity.

What starts growth may not perpetuate it. Ordered deals often emerge when they are closed – when spoils are divided among a small elite.⁵⁰ Yet for growth to be perpetuated, deals must become open while remaining ordered. Different political-economic factors may drive deal opening to those that first lead to ordered deals.

Not all growth episodes are equal, as negative feedback loops may reduce the prospects for growth maintenance. The distribution of growth across the economy will directly affect the rent space, leading to a new balance of business interests. When rentiers and powerbrokers are the primary beneficiaries of a growth episode, no matter how rapid, there is unlikely to be more pressure for inclusive deals and policies. Political finance to sustain the political settlement is more readily available through the tighter links between government and business in those quadrants.

Growth episodes characterized by weakening state capacity and closed deals are likely to result in an erosion of legitimacy. When growth is driven by closed deals, gains are likely to be narrowly shared, with crony elites the primary beneficiaries. Indeed, such a volatile situation was a contributor to the Arab Spring and wider weak legitimacy across the region.⁵¹ Similarly, when growth is not accompanied by investment in basic state functions, legitimacy is reduced⁵² and the factors of production that might lead to structural transformation are left unattended.

One consequence of low legitimacy resulting from weak state capacity is a rise in preference for clientelistic governance, which exacerbates the feedback loops. Fergusson, Molina, and Robinson find in Colombia that tax evasion, a measure of low state capacity, and vote-buying, a measure of clientelism, go hand in hand.⁵³ Growth episodes in this type of environment may thus favour dividing the spoils among those inside the political settlement, rather than investing in inclusive growth.

Structural transformation is another key attribute of a given growth episode. Investment in state capacity and open deals is likely to contribute to growth opportunities in workhorse and magician sectors. It is these sectors that are associated with increasing complexity⁵⁴ in the economy, and moreover, that are more likely to advocate for open and ordered deals and further investment in state capacity. This is what structural transformation looks like in the deals and development framework.

State fragility is affected by the nature of the growth episode. *Political violence* is likely to be sustained when growth generates narrow gains for elites who are able to redirect it to violent activities that sustain the political settlement. This is likely to close the deals space and depreciate state capacity even more, further eroding legitimacy and increasing the incentives for violence. *State ineffectiveness* is perpetuated by growth episodes that reduce legitimacy and structural transformation and increase the power of business cronies and repressive forces in the political settlement.

Key questions



- Is growth reinforcing closed political settlements, or opening up the space for political participation?

- What sectors of the economy and specific businesses/business groups are benefiting from the growth episode?
- Are new products and services emerging in the growth episode?
- What kind of political finance and effects on fragility is the growth episode creating?
- Is wealth creation leading to economic opportunity and investment in state capacity?

Example: Somalia

Somali businesses face a largely disordered deals environment, complicated by overlapping governance claims by the Federal Government of Somalia, local clans, and Al-Shabaab. More-ordered deals exist in narrow sectoral and geographic realms. With limited export earnings, decentralized aid, and high remittances, the economy is based on consumption. Limited opportunities for productive investment outside the closed deals in the powerbroker space result in weak economic growth. With mostly closed deals, concentrated participation in the political settlement, and competing sources of authority, legitimacy fails to build in the central government. Feedback loops reward powerbrokers able to dominate their narrow slice of the domestic market through political protection, further weakening any pressure from the rent space for positive reforms. The concentrations of economic activity and reliance on consumption create a 'fixed pie' mentality, which provides further incentives to political actors to maintain the ability to deploy violence rather than invest in state functions.

Possible interventions

- Punish rights-violating cronies, such as through targeted sanctions
- Encourage the use of growth dividends to invest in state capacity and inclusive economic policy
- Protect incremental efforts in the move towards open deals
- Preferential trade, investment, and diplomatic efforts to encourage emerging business and political successes that favour inclusive growth



Potential risks



- Donors conflate growth with institutional performance and reward a regime that might already be self-dealing through closed deal-fed growth
- High growth sometimes means that patronage pressures increase, resulting in fragility later
- Investments in education in the absence of job creation can lead to dissatisfaction and reduced legitimacy

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3 OPERATIONALIZING THE FRAMEWORK

The deals and development framework presented here is far from a 'plug and play' application. Rather, it is meant to guide deep, context-specific analysis by skilled policy advisers. Instead of providing answers or a prescribed set of interventions, it is designed more to stimulate probing questions and new framings of the challenges of growth in fragile states.

Given the importance of economics, governance, conflict analysis, and diplomacy, a multidisciplinary team of advisers can work together to implement the analysis and policy design. Often, analysis and even policy design occur in silos, yet the challenges of fragile and conflict-affected states do not know such boundaries. Working across functional teams should bring a deeper level of understanding and result in more nuanced and co-ordinated intervention.

Most fragile state contexts are internationalized, underscoring the importance of a regional approach. Most fragile states have sources of instability on their borders, including the training or funding of non-state violent actors⁵⁵ and the spillovers from a neighbouring country's refugee exodus.⁵⁶ Thus, ideally a comprehensive political economy policy intervention around economic growth in a fragile state should be linked to the same in neighbouring countries.

A global community of practice would enhance the effectiveness of working with and applying the deals and development approach. The application of the framework to Somalia, South Sudan, and the Democratic Republic of the Congo revealed many similarities. Experiences working with the framework and generating policy prescriptions in one country may have value to others engaged somewhere else. Through a global community of practice, an evidence, application, and analysis bank could be built that would enhance the effectiveness of the approach.

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