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The Investment Climate in Post-Conflict Situations

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Abstract

This paper is a policy review of the role of the investment climate in post-conflict situations. It summarizes the broad range of ways in which conflict negatively impacts the investment climate, from macroeconomic instability to a degraded regulatory framework. It stresses that attention needs to be paid to the broader 'enabling environment', including institutions, governance, capacity and social capital. It suggests that a vibrant private sector underpinned by a good investment climate is particularly important in the post-conflict recovery phase for three reasons: it generates employment, it provides public services where the state has retrenched and it builds social capital. By addressing these important 'greed and grievance' factors, the private sector helps reduce the likelihood of a return to conflict.

The paper finishes by distilling key lessons relating to the management of the post-conflict reform process. Despite the central importance of a good investment climate, greater effort is needed to ensure that private sector development (PSD) reforms are included in the first-round of post-conflict policymaking. Local ownership of reforms, and enhanced local capacity to implement them, is key to sustainable improvements in the investment climate. Development partners have an important role to play here in facilitating dialogue and promoting partnerships between public and private sector stakeholders. At the same time, development partners need to ensure that their presence in fragile post-conflict economies does not damage the very sector they are trying to support.

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Executive Summary

A good investment climate provides a platform for vibrant private sector activity. Conflict corrodes this platform. It reduces physical security, undermines macroeconomic stability, threatens the rule of law, dries up access to credit and financial services, destroys infrastructure, distorts labor markets, disables the regulatory framework, and dismantles the tax system. The toll is a heavy one.

Efforts to repair this damage to the investment climate in the post-conflict phase need to pay careful attention to the broader 'enabling environment.' Experience shows that issues such as the quality of institutions and governance, government capacity to implement reform, the political economy, and the stock of social capital are critical in determining whether otherwise sound policy reforms gain traction.

While building a good investment climate is important in any developing country, it takes on particular importance in post-conflict situations for three reasons. First, the private sector generates sustainable employment. The opportunity to get a job is especially important for demobilized ex-combatants, giving them a stake in the peace process.

Second, the private sector can fill the gap left by the reduced capacity of governments to deliver public services in the post-conflict period. Small scale private providers can be quick off the starting block in delivering a range of services—including electricity access, water and telecommunications—following the end of hostilities.

Third, the resumption of private sector activity can, of itself, re-build public trust and social capital. While business has played a role in supporting 'conflict economies' in some cases, the broader web of relationships spun by private sector transactions can extend across social, income and geographical divides, and sometimes even across borders.

These three factors—jobs, public service delivery and social capital—are key to addressing some of the principal 'greed' and 'grievance' factors that increase the possibility of a relapse into conflict. In other words, the private sector plays a vital, but under-acknowledged, role in cementing the peace.

Having reviewed how conflict affects the investment climate and why it matters, the paper finishes by considering what should be done differently. The focus is on the process of prioritizing and implementing appropriate policies—rather than the details of the policies themselves—and the role of external development partners in supporting that process.

First, despite the compelling case for bringing the private sector development (PSD) agenda into the heart of the post-conflict policy framework, it has largely been left off the table in the first round of reforms. Introducing them in a second round can be difficult, as vested interests emerge and the enthusiasm for further reform wanes. More needs to be done to ensure that improving the investment climate in order to kick-start the private sector receives more attention immediately following conflict.

Second, generating ownership of reforms, and enhancing local capacity to implement them, is key to sustainable improvements in the investment climate. Dialogue and other consultative measures among the full range of stakeholders can be an important means to achieve this.

Third, developing partnerships between the public and private sectors early in the post-conflict period—including with the diaspora—is an important component of rebuilding a strong investment climate. Investors have more knowledge than governments about the hurdles they face in running their businesses, and public and private sectors can also form a common front to push forward the reform agenda. Development partners have an important part to play in encouraging stakeholder dialogue and fostering public-private partnership, but it does call for them to take on new roles as facilitators, 'honest brokers,' and implementation supporters.

Fourth, investment climate reforms, as with any other reforms, do not come as a coherent package. Tough trade-offs need to be made and careful attention paid to sequencing. A particular challenge is the extent to which the policy framework that shaped the investment climate before conflict should be re-adopted. With a new government team in place, the post-conflict phase can represent a rare window of opportunity for PSD-friendly reforms. Yet there are also risks in developing overly ambitious plans that may be slow to implement. In situations where significant policy and institutional reforms are being undertaken, it can be useful to deliver 'quick wins' that buy time and build confidence in the government's commitment to reform.

Finally, the very presence of development partners in post-conflict situations can have a negative impact on the investment climate. Both the flow of aid, with its accompanying macroeconomic effects, and of aid workers, with their demands for housing and skilled labor, can distort the local private sector economy. Development partners need to be aware of the impact of their activities and ensure that the local private sector is more fully involved in post-conflict reconstruction activities.

The Investment Climate in Post-Conflict Situations

1) INTRODUCTION

Conflict has a far-reaching impact on the private sector. It damages the fundamental structures that underpin private sector activity, pushing businesses into the informal sector and forcing entrepreneurs to find new ways to operate. The implications are far-reaching: a diminished private sector means fewer jobs, lower incomes and damaged livelihoods.

As countries and regions emerge from periods of conflict, one of the most pressing challenges is to re-establish an investment climate conducive to private sector activity. A strong investment climate provides the conditions necessary to put labor and capital back to work, creating jobs and wealth. Private sector activity can also play an important role in delivering public services and, more subtly, start to replenish some of the social capital that is destroyed during conflict. In these ways, getting the private sector back on its feet becomes a vital factor in cementing the peace and setting countries on a sustainable path to peace and development.

This paper explores these themes. It provides an overview of how conflict affects the investment climate and underlines why it is so important to promote an investment climate that supports private sector activity in the period following conflict. It is structured as follows:

- Section 2 summarizes the range of ways in which conflict negatively impacts the investment climate and what this implies for post-conflict policymaking;
- Section 3 provides an overview of why an investment climate conducive to private sector development (PSD) is particularly important in the post-conflict recovery phase;
- Section 4 distills key lessons for development partners relating to the management of the post-conflict reform process;
- Section 5 concludes.

These are issues where the World Bank Institute is actively engaged through its Investment Climate Capacity Enhancement Program. One of the overarching messages to emerge is that while it is important to get the policy framework right, it is equally important to get the policymaking process on the right track—and this requires local capacity to formulate and implement policy decisions. In the fragile political climate that follows conflict, the way in which PSD reform is approached can be as important as the reforms themselves.

Some caveats. First, this paper is intended to be a brief review of certain aspects of the investment climate in post-conflict situations, not a comprehensive toolkit or blueprint for post-conflict PSD reforms. The main objective is to highlight the relative lack of attention paid to the investment climate after conflict has ceased, and to point out some of the most important issues of *process* that need to be addressed. Second, we have made no great typological efforts to define ‘conflict.’ Some countries will experience wars whose end can be definitively marked. In others, low-level insurgency may persist for decades. And in many situations, ‘country’ is the wrong organizing unit. Inevitably, this paper generalizes about the actual nature or intensity of conflict in any given

context.[1] Three, it needs to be borne in mind that countries emerge from conflict under differing and unique conditions and any general lessons outlined here must be adapted to realities on the ground. In particular, the nature of the post-conflict regime varies. In some countries, such as in Liberia currently, the new government is explicitly committed to reducing poverty and works closely with the international community. But in others, the new regime may have little interest in improving its citizens' prospects. In these situations, any of the conclusions in the last section of this paper are rendered irrelevant.

[1] However, all the conflicts discussed here meet the criteria of the Uppsala Conflict Data Program, which defines an armed conflict as concerning government and/or territory where the use of armed force between two parties, of which at least one is the government of a state, results in at least 25 battle-related deaths. See http://www.pcr.uu.se for more details.

2) THE IMPACT OF CONFLICT ON THE INVESTMENT CLIMATE

Overview of the Investment Climate

Drawing on the 2005 World Development Report, *A Better Investment Climate for Everyone*, the investment climate can be understood as the set of factors in a given location that shape firms' incentives and opportunities to invest, grow and create jobs. Some of these factors are costs; others are risks; still others are the competitive forces in the economy. Together, they determine the vibrancy and reach of private sector firms in the economy. A strong investment climate is not a serendipitous occurrence: it is the result of country authorities formulating, implementing and enforcing an appropriate set of policies.

The various aspects of the investment climate can be usefully divided into four broad policy pillars. Each can be an important contributing factor to—or binding constraint on—the viability of the private sector.

In the fluid and chaotic context of a post-conflict economy, formulating an appropriate set of policies is only half the battle. While any of these specific policy factors listed above can, depending on the country context, act as a binding constraint on private sector activity, the broader 'enabling environment' is key to ensuring that reforms make it off the drawing board. There are several important aspects here that cut across all four 'policy pillars' of the investment climate, which are often neglected in post-conflict interventions, including by development partners. They include the strength and authority of institutions, the governance environment, the broader political economy, the capacity of government at all levels to implement policies and the social capital or 'trust in society' that exists in the affected country. Conflict can damage each of these enabling environment factors, to the detriment of any attempts to improve the investment climate. While they are by no means unique to private sector development, each plays a critical role in determining whether or not a post-conflict PSD policy agenda gains traction.

Figure 1. Pillars of the investment climate

Security and stability	Finance and infrastructure	Workers and labor markets	Regulatory framework and taxation
• Physical security • Macroeconomic stability • Contract enforcement and judicial redress • Land and property rights	• Access to credit and financial services • Access to utilities (power, water) • Infrastructure (telecoms, transport)	• Supply of skilled labor • Ease of hire and fire	• Red tape (permits, licenses, registration) • Customs • Tax policy/rates • Tax administration

← **'Enabling environment'** →

Institutions • Governance • Political economy • Capacity • Social capital

The following section surveys the impact of conflict on the four policy pillars of the investment climate, as well as the broader enabling environment.

Security and Stability

Physical security

The physical security needed to meet customers, discuss contracts and ship or pay for goods and services is a basic prerequisite for investing and doing business. Even in the most insecure conflict situations, business somehow gets done and the 'coping strategies' of the private sector are legendary.[2] Yet a lack of physical security changes the nature of business life, which becomes less transparent, less competitive and demands greater reliance on personal contacts. Individual business transactions are fewer in number and smaller in size. With fewer opportunities to benefit from economies of scale, private sector activity becomes less efficient. In more extreme cases, businesses may become the target of kidnappings and extortion due to their access to money and resources. In places such as in Iraq, the security situation is an almost totally limiting factor to any private sector activity beyond the small and informal.[3] International investors and tourists are most likely to have physical security concerns, particularly given their options simply to go elsewhere.

The restoration of physical security is thus a prerequisite for restoring vibrant private sector activity. The perception of physical security is at least as important as the actual risk profile, with risk-averse behavior by non-local investors and customers (including tourists) leading to a lag between the return of a relatively secure environment and the resumption of activities by non-local actors.

Macroeconomic stability

Conflict situations are usually accompanied by a high degree of macroeconomic instability and, at worst, a complete breakdown of the monetary and fiscal machinery.[4] The economic legacy of war affects private firms directly—for example, a shattered financial sector cuts off access to working capital and eliminates non-cash transactions. It also act as a general drag on economic activity—for example, depleted foreign exchange reserves impede cross-border transactions, severe debt overhangs provide disincentives for foreign investment and high inflation, amongst other effects, poses challenges to private contract formation.

The disruption of exports by conflict has macroeconomic implications once conflict recedes. While imports can pick up relatively quickly, particularly for goods associated with post-conflict reconstruction, exports tend to lag. This is due both to supply and demand side factors: on the supply side, productive capacity is reduced and export infrastructure (airports, ports) damaged; on

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[2] For example, in Somalia, despite the lack of a central government since 1991 and an acute lack of physical security, there are nine telecom companies operating, with over 112,000 fixed line and 50,000 mobile subscribers. See Nenova and Harford 2004.
[3] Langford 2005.
[4] Some institutions, though, seem to defy economic gravity. For example, the Somali shilling has continued to operate through 14 years of civil war without a central bank or reserves of any kind. www.economist.com/World/africa/displayStory.cfm?story_id=5313559&tranMode=none

the demand side, international commercial links are cut as foreign customers switch to more reliable suppliers during the conflict period. As a result, balance of payments gaps in most post-conflict countries widen. This is exacerbated by capital flight as a rational business response to protect financial assets, which further weakens an economy's financial depth. In some cases, non financial assets such as property may be sold and the capital expatriated.

The relative difficulty of exporting in the post-conflict phase can also have a structural impact on post-conflict economies, by increasing the relative profitability of the non-traded sector vis à vis tradables. This provides incentives for private sector investment and activity in the non-tradables sector—for example, in construction and commerce—distorting the economy over the medium to long term.[5]

Contract enforcement & property rights

One legacy of conflict is an almost complete breakdown of the legal system, including for commercial cases. Although the *de iure* legal framework—including legislation, civil procedure and commercial codes—will tend to remain in place, the *de facto* legal framework for the private sector in most cases ceases to apply. Civil benches do not sit, case backlogs build up, and judgments are not enforced. From a private sector perspective, this affects the ability of firms to enforce contracts and resolve commercial disputes, which in turn provides disincentives for firms from entering into formal transactions with unknown parties. While commercial dispute resolution is a problem in many developing countries, it is particularly acute in post-conflict situations, particularly if enforcement capacity is non-existent.

A lack of judicial redress also has implications for land and property rights. The disruption caused by conflict includes the 'informal' expropriation of property. In the post-conflict phase, this leads to disputes over rightful ownership—which are unlikely to be rapidly resolved given a weakened judicial system. This in turn has implications for the ease with which firms can raise financing, given the difficulties of pledging collateral (including residential property). In the immediate post-conflict period, there are likely to be large backlogs of unresolved commercial and property disputes, in conjunction with an under-resourced judicial system and political uncertainty. In this context, innovative means of resolving disputes, including arbitration, mediation and other alternative dispute resolution mechanisms, become potentially important tools. At the same time, they should not undermine the importance of rapidly re-building a reliable and trusted legal framework for business.

Finance and Infrastructure

Access to credit and financial services

Conflict disrupts formal payment systems and the financial intermediation function of the banking sector, two vital components of the private sector enabling environment. Without a functioning

[5] Bruck, Fitzgerald and Grigsby 2000.

banking and payment system, business transactions must rely on cash and cannot access formal credit. Businesses that need credit for working capital (for example, to purchase inputs or goods for on-selling) have to rely more than usual on informal financial services, which are more expensive, unregulated, and limited in range.

The juxtaposition of a lack of a functioning payments system with low levels of physical security in a post-conflict situation can pose particular problems. Following the war in Sierra Leone, for example, banks were absent in a large part of the country and the logistics for moving money across the country were weak.[6] The lack of physical places to store physical cash and the lack of security for large cash transactions limit the size of business deals, acting as another drag on private sector activity.[7]

Infrastructure

The physical degradation of infrastructure is one of the most tangible legacies of conflict. Infrastructure services facilitate the diversification and specialization of production, and the expansion of trade. Without the rehabilitation of infrastructure, economic growth potential will be limited. However, infrastructure components that comprise vital cogs in the machinery of the private sector are also first in the firing line during conflict: transport links (bridges, roads), energy and fuel facilities (power stations, electricity distribution hubs, fuel depots), telecommunications (fixed line and mobile) and trade facilities (ports, airports). In addition to its importance to private sector activity, the rapid restoration of essential infrastructure services following conflict assists in the perception of a return to normality, contributing to the reconciliation process.[8]

While the impact of the destruction of physical infrastructure weighs on all private sector actors, it is particularly damaging to larger, formal firms and exporters. Firms in the manufacturing sector are likely to have degraded physical plant (either through direct conflict damage or through an inability to perform maintenance), may lack access to power, and face significant problems in transporting inputs and finished product. Exporters face the challenge of physically accessing foreign markets.

Some infrastructure sectors recover faster than others. One study found that telecoms investments, particularly mobile telecoms, materialize immediately after (sometimes even before) the end of the conflict, and represent the lion's share of investment for the first five years of the post-conflict period.[9] Other sectors attract less investment. Energy projects, particularly in generation, start to emerge about three years after the conflict and increase in frequency after five. Private investment in transport comes later, and the water and sanitation sector—despite having the greatest needs—tends to come last of all, reflecting the high capital costs and constrained regulatory environment.

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[6] Isima 2004.
[7] See Lister and Pain 2004.
[8] DFID 2005.
[9] See Schwartz, Hahn, and Bannon 2004. The infrastructure package for rolling out mobile phone networks has been largely commoditized, with minimal country-specific engineering requirements. The infrastructure is also rapidly deployable, allowing operators relatively quick returns on their initial investment.

Workers and Labor Markets

The set of issues concerning jobs, workers and labor markets constitute one of the most significant ways in which the PSD agenda differs in post-conflict situations. Conflict undermines economic activity, as factor and product markets are disrupted. As economic opportunities dwindle, un- or under-employment surges. Jobs in the formal sector are particularly vulnerable. The demobilization and reintegration of ex-combatants compounds the problem. The end of war generally sees a flood of new and mostly unskilled labor into urban areas, depressing further the already low price of labor.[10]

There are severe skills shortages in the labor pool in conflict-afflicted countries. Ex-combatants, in particular, are likely to have limited education and few marketable skills, complicating their absorption into the post-conflict economy. Demobilization, disarmament and reintegration (DDR) programs often focus on re-building these skills. For example, in Sierra Leone, out of 70,000 ex-combatants who had been discharged, over 35,000 have been put through training programs that aim to build vocational skills.[11] In some cases, a role for the private sector in supporting ex-combatant reintegration is explicitly envisaged in the DDR program, through providing training and job opportunities for former soldiers. In Afghanistan, for example, local businesses were provided incentives to engage in the DDR program by being offered trainees at no cost for 4–12 months.[12]

Regulatory Framework & Taxation

Regulatory frameworks and informality

Following a conflict, the pre-existing business regulatory framework for the private sector is likely to remain on the books, but it is unlikely to be fully, coherently or fairly implemented. In other words, as with the legal framework, the gap between the *de iure* and *de facto* regulatory framework is likely to be very wide. This is the result of the very limited enforcement capacity that remains in government departments and agencies following conflict.

When the normal rules of doing business—registering businesses, obtaining licenses, observing contracts—are not enforced, firms operate in a manner similar to the informal sector in non-conflict situations. Even if the government retains some administrative capacity, many firms may move operations into the informal sector, in order to lower the profile of the business in an uncertain security and regulatory environment.

As a result, the business sector in post-conflict environments is likely to consist mainly of informal SMEs, with very few formal businesses remaining in operation. This poses problems for private sector participants. Because of its unregulated nature and the difficulties of enforcing

[10] Note that, in some cases, conflict may drive up the price of labor. In Eritrea, targeted conscription drives by the military resulted in a shortage of, and hence high cost for, white-collar labor. In such a scenario, where labor is a binding constraint on economic activity, the freeing up of the labor market following conflict may lead to a surge in productivity and exports. Conflict and Labor Markets in Manufacturing: The Case of Eritrea, World Bank.
[11] Ginifer 2003.
[12] International Alert 2006.

Box 1. Moving into the informal sector

Informal sector activity—that is, legitimate business activities that do not fully comply with regulatory and tax requirements—is particularly prevalent in post-conflict situations. Many of the informal "SMEs" operating in the private sector would be unrecognizable as businesses in any traditional sense. This includes individuals normally working in other sectors who have been forced into small-scale private transactions—such as street trading—as a coping mechanism.

Firms cease operating in the formal sector during conflict for a variety of reasons:

- The general slowdown in economic activity particularly affects formal firms with a fixed cost base (including full-time employees) and heavy regulatory costs (including taxes)
- An uncertain security and regulatory environment leads company owners with a fixed workplace or office to close down operations and in many cases expatriate any liquid assets. Firms that can move part or all of their operations into the informal sector do so to lower their profile
- In some cases, a breakdown in public administration renders all private sector activities informal *de facto*

This 'marginalization' of formal firms means that development partner PSD activities that have traditionally focused on the formal sector—including analytical products, such as ICAs, and loan operations—need to be extended to consider if and how informal firms should be encouraged to (re)enter the formal sector in the post-conflict period.

contracts, operating in the informal sector increases risk and vulnerability for participants, requiring greater reliance on social networks.[13] Informal sector activity also tends to be less efficient, with lower levels of investment, fewer economies of scale and a more localized customer base. In short, by pushing enterprises into the informal economy, conflict acts as a heavy drag on economic activity. It also means that a new generation of entrepreneurs start their business lives outside a framework and culture of regulatory compliance—compounding the problems of restarting formal sector activity once conflict ends.

However, a high degree of informality does not mean that businesses in a conflict zone operate in a regulatory free-for-all. Depending on the situation, the business environment will tend to be characterized by some combination of two patterns:

- Existing rules and implementing agencies remain in place, but are implemented in an environment where accountability is reduced or non-existent. This may lead to arbitrary or predatory enforcement—for example, soldiers collecting unofficial 'taxes'—with no means of redress for private sector actors.

[13] Langford 2005.

Box 2. Unfree markets in Afghanistan

A relatively small group of businessmen dominate major trading activities in Afghanistan. Through a variety of mechanisms and processes they actively exclude competitors and have positioned themselves to be the major beneficiaries of growth in the sectors in which they are involved. Key tactics that they deploy include:

- Price manipulation
- Political influence
- High levels of vertical integration at the 'top' of the chain (that is, their companies own other companies or service-providers with which they do business)
- Influencing capital allocation patterns (when credit is unavailable to others) and the ability to place orders in cash

Source: Lister and Pain (2004).

- The vacuum left by the lack of an 'official' bureaucracy to implement the 'official rules' is filled by new 'unofficial' or informal actors. This need not mean a lighter regulatory touch. In fact, the new informal institutions or informal social regulation may be highly restrictive and hence inefficient from an economic perspective. In Afghanistan, for example, non-formal economic activity has been highly regulated by unofficial processes that actively restrict competition and participation. [14]

Fiscal policy

In most post-conflict situations, the fiscal base has been severely depleted, with a small rump of companies remaining in the formal sector. The composition of fiscal revenues in post-conflict economies usually differs from non-conflict countries. As economic activity declines and fewer firms remain in the formal sector, revenues from indirect taxes and VAT fall and governments become more dependent on import duties and other trade taxes.[15]

This means that a tightrope needs to be walked, balancing the need for fiscal resources for reconstruction and public service provision against the importance of a tax structure that does not entirely provides disincentives for firms from (re)entering the formal sector. In many cases, the temptation has been to tax business activities too heavily, which strengthens the incentives for firms to remain in the informal sector.

Enabling Environment

Institutions, like physical infrastructure, suffer during conflict. The formal governmental, regulatory, legislative and judicial processes that determine and implement the 'rules of the game'

[14] Lister and Pain 2004.
[15] Addison, Chowdury and Murshed 2002.

for private sector firms are severely degraded or become fragmented. From a 'top-down' perspective, the circumvention of the normal rules of government undercuts the legitimacy of some institutions, and systems of checks and balances may break down. Court rulings may be left unenforced and institutions such as central banks run for short-term political ends. From a 'bottom-up' perspective, the chaos of conflict may see senior officials leave or be pushed out from key institutions, undermining their effectiveness. In the post-conflict period, re-starting the functioning of the principal institutions and re-establishing their legitimacy is key.[16]

The breakdown of governance norms associated with institutional weakness can lead to rampant corruption. The combination of an insecure physical environment and a dysfunctional legal system presents extensive rent-seeking opportunities for unscrupulous individuals. In the absence of a well-governed state, rent-seeking systems develop at both higher and lower levels of the public service. Poorly-paid officials may start collecting bribes, while at higher levels of the bureaucracy, senior officials may take advantage of administrative disorder to extract rents from, for example, mining concessions and mobile phone licenses.

The political economy of the post-conflict environment also influences reform efforts, often in subtle ways. Reforms need to be sensitive to the specific political context of a country. In particular, the nature of private sector participants in a post-conflict environment may differ from a non-conflict situation. There is usually an implicit assumption in PSD discussions that private sector participants are 'passive' actors whom, while engaging in dialogue with regulatory authorities, ultimately operate within the rules of the game.[17]

However, not all private sector actors are disinterested enterprises operating in a commercial sphere that is wholly separate from the political context. Some businesses may directly benefit from conflict, thus helping to sustain it, as has been pointed out in the recent literature on 'conflict economies.'[18] For example:

- In *Afghanistan*, one legacy of war has been the emergence of a group of warlords who combine political power with significant business interests. These individuals, sometimes dubbed the 'combatant economy,'[19] may use their political power to re-shape the business environment in their favor. This politicization of the business environment is even more problematic when these business interests are illegal—such as in the opium industry in Afghanistan—as this directly undermines the re-establishment of the rule of law.

[16] Note that the degree to which the government machinery functions following conflict is not usually homogenous across a country. Depending on the political geography of the conflict, there is usually weaker bureaucratic presence and capacity in non-urban areas, meaning that rural and urban enterprises may face different challenges.
[17] While private sector firms are often represented by business associations who undertake lobbying activities on their behalf, these business associations are not usually involved in decision-making that determines the regulatory framework. Also, some state-owned enterprises may have more influence than other firms.
[18] See International Alert 2004. It also points out that, during conflict, many enterprises adopt 'coping' tactics, undertaking whatever economic activity is available for them to survive. These activities may have either conflict-sustaining impacts (such as undertaking trading activities with rebel groups, or paying bribes and protection money to armed groups) or conflict-reducing impacts.
[19] Taylor 2003.

- In *Sudan*, there is a complex relationship between the government, the military and the private sector in the north of the country, with individuals being part of or closely linked to all three.[20]
- In *Bosnia*, 'crony capitalists' with close links to the new post-conflict regimes captured state assets and engaged in monopolistic business practices, damaging the investment climate, shutting off business opportunities to new entrepreneurs and exacerbating corruption.[21]

A lack of capacity resulting from conflict, both to make and implement policy, is a critical weakness in post-conflict situations. Government lacks the capacity to ensure physical security and to re-build infrastructure. Government regulatory agencies, such as customs administrations or licensing authorities, lack the personnel and skills to administer the regulatory framework for business. Courts lack the capacity to enforce contracts. This lack of capacity also extends to the private sector, which is usually fragmented by conflict. Business associations fall into disuse, limiting collaboration between private sector enterprises and their ability to undertake advocacy with the public sector for an improved investment climate. Investors lack the capacity to innovate and finance new business ideas. Rapidly shoring up the capacity of the full range of stakeholders—public and private—both to plan and to implement reforms in the post-conflict period is crucial.

Finally, conflict has an impact on social capital or 'trust in society.' As well as breaking down the bonds of trust between individuals, conflict can diminish professional trust. From a technical perspective, unwillingness to enter into transactions with unknown parties—because, for example, contracts cannot be enforced—will tend to reduce the size and frequency of transactions. This compounds the effects of a high degree of informality in a post-conflict economy. More broadly, where a lack of trust is generalized to whole groups—for example, where conflict was fought along ethnic lines—the private sector can become Balkanized, with private firms collaborating only within respective ethnic groupings.

[20] Langford 2005.
[21] International Alert 2004.

3) THE IMPORTANCE OF THE INVESTMENT CLIMATE IN POST-CONFLICT SITUATIONS

The previous section underlined the wide range of ways in which conflict negatively impacts the investment climate, both in specific policy areas and in the broader enabling environment. This section provides an overview of why a strong investment climate is so important in post-conflict situations. The arguments for a strong investment climate in any context have been well-rehearsed elsewhere, particularly in relation to supporting economic growth and creating jobs and new livelihood opportunities.[22] But in addition, in post-conflict situations, the private sector can also become a mechanism to deliver vital public services in situations where government capacity is much diminished. More subtly, the web of connections that private enterprise builds are an important means of rebuilding social capital.

These three factors—jobs, public service delivery and social capital—are key to addressing some of the principal risk factors for a return to conflict. While the debate on the causes of conflict rumbles on in the academic literature,[23] most analysts accept that a complex (and context-specific) mix of 'greed' and 'grievance' factors explain the motives for conflict, including relapse into conflict following a peace agreement. The role of the private sector in addressing both of these factors through generating jobs, delivering public services and boosting social capital means that it can play a vital, but under-acknowledged, role in cementing the peace.

Employment

Without jobs, individual livelihoods are threatened and dependants cannot be provided for. For many combatants, conflict itself is a livelihood, albeit a desperate one. In a post-conflict situation, large groups of demobilized ex-combatants who lack any means of supporting themselves are a natural constituency for those seeking to re-ignite hostilities.[24] The successful generation of employment opportunities gives individuals a stake in success of the peace process, helping to stabilize a volatile political environment.

Public works and infrastructure reconstruction projects can absorb some excess labor in the short to medium term. In Liberia, for example, a "jobs for guns" program persuaded fighters to lay down their arms and provide labor for infrastructure rehabilitation projects,[25] while in Timor Leste, the World Bank's first post-conflict operation funded urban rehabilitation jobs.[26]

However, the private sector is fundamental to resolving the jobs problem in a sustainable fashion over the longer term. Public works are not a sustainable or scalable source of employment

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[22] As the 2005 *World Development Report* puts it, "a good investment climate fosters productive private investment…creates opportunities and jobs…and expands the variety of goods and services available."
[23] The now-classic paper that kick-started the debate on 'greed vs. grievance' was "Greed and Grievance in Civil War" (Collier and Hoeffler 2005).
[24] See, for example, Human Rights Watch 2005.
[25] Hoeffler 1999.
[26] World Bank 2000.

Box 3. The role of microfinance in post-conflict environments

Given the breakdown in the formal financial sector during conflict, microfinance has become a principal source of credit for the SMEs that are the main private sectors actors in post-conflict environments. Experience with microfinance institutions (MFIs) in several countries suggests that it is an effective means of reaching the smallest micro-enterprises, not least because MFIs do not rely on formal enforcement mechanisms and are thus able to operate in almost any governance environment (and many MFIs are created and operated entirely in the informal sector). In Cambodia, following thirty years of war and instability, the financial system was virtually non-existent. Eight years later, over 340,000 clients were accessing microfinance services. Similar success stories can be found in Liberia and Kosovo.

Several lessons emerge. Among others, the business environment must be relatively secure, there must be a minimum level of economic activity and demand for financial services, and operations must be built up over time. Perhaps most importantly, microfinance must be approached as a long-term source of financial services for SMEs—it is neither a post-conflict reconstruction grant, nor a conflict resolution tool.

Sources: USAID (nd).; CGAP (2004).

beyond the medium term and PSD interventions that catalyze job creation, whether in the formal or informal sector, over the medium to long term are essential. It is also important to note that, initially at least, the informal sector is the most likely source of jobs in a post-conflict situation.[27] While stimulating the creation of jobs in the formal sector is an important long run goal, it should not come at the expense of curtailing informal employment in the interim. Job-generating private sector economic activity needs to be encouraged, no matter where it takes place.

Capacity to Deliver Services

Given the limited capacity of governments to deliver public services in the post-conflict period, the private sector can play an important role in plugging the gap. Conflict damages both the physical and logistical infrastructure used for the delivery of a wide range of essential public services, including electricity access, telecommunications and water & sanitation facilities. In many situations, private sector suppliers are quicker to re-establish these services than public sector providers.

Telecommunications is one area where private sector providers are famously fast in providing services, often in areas that are still in conflict. In Somalia, competition between nine telecoms companies—with over 50,000 mobile phone subscribers between them—has driven prices down to some of the lowest in Africa, with local calls costing less than 10 cents/minute and international calls available for less than $1/minute. These mobile phone networks also facilitate local commerce and the transfer of funds to and from abroad via *hawala* networks, including remittances.[28] The private sector can also supply basic infrastructure and services that are more traditionally associated with government providers. For example, in Somalia, micro entrepreneurs

[27] Langford 2005.
[28] Nenova and Harford 2004.

Box 4. Small-scale private sector service provision in Cambodia

Between 600 and 1,000 small private power systems operate in Cambodia, serving nearly half a million customers or nearly as many households as the national power company. They account for about half of the country's generating capacity. Most of these businesses were set up by local entrepreneurs before the interim government assumed power in 1991, and were distributed throughout the countryside, effectively filling the void left by the nonfunctioning national utility.

Similarly, small-scale private companies treat and deliver water via piped and metered systems throughout the Cambodian countryside. As with the power companies, these businesses are built almost entirely with a combination of local equity and informal or family borrowing.

Source: Schwartz, Hahn and Bannon (2004).

provide water in rural areas and electricity is now available from private providers in areas where it was not available in the pre-1991 economy.[29]

In addition to delivering a wide range of services, the private sector invests in the infrastructure that underpins these services. The flow of investment by the private sector into infrastructure following conflict tends to be counter-cyclical to official aid flows. Post-conflict situations are typically marked by a burst of official aid in the initial years, but this tends to taper off rapidly after about four to five years.[30] Yet it is at this point that significant private investment, largely in infrastructure, starts to flow, after there has been a sufficient period of post-conflict stability to reduce the perceived risks.[31] Through developing infrastructure capacity in this way, the private sector plays an important role in filling the gap in public service delivery.

Building Social Capital

The development of the private sector may, of itself, build public trust and strengthen state institutions in the post-conflict period. Business and investment can be among the few remaining points of contact between two sides during a conflict and can do much to repair societal ties in its aftermath. At the level of individual transactions, entrepreneurs acting in their own self-interest who enter into a deal with an unknown counterpart may end up reaching across invisible barriers and building trust in ways that daily household transactions do not. The web of business transactions that characterizes a vibrant private sector extends across income and social groups, connects the rural and urban economies, and sometimes even bridges borders.

Dialogues organized by the private sector have, by bringing business representatives from both sides of the conflict together, enhanced social capital in some situations. For example, the 'Turkish-Armenian Business Development Council' was founded by an Armenian and a Turk in

[29] Nenova and Harford 2004.
[30] See, for example, World Bank 2004, where a 2002 study in Cambodia showed that government resources were able to cover less than one-third of the total annual cost of infrastructure rehabilitation and maintenance.
[31] Schwartz, Hahn and Bannon 2004.

Box 5. 'Trading with the enemy': a tale of two markets

Sadakhlo market was situated in Georgia, but close to the border of Armenia and Azerbaijan. With up to 5,000 people attending on a busy day, it was the main source of income for tens of thousands of Armenians, Azeris and Georgians. Even at the peak of the war between Armenia and Azerbaijan, ordinary Azeris and Armenians continued to trade at Sadakhlo, with traders from each country reaching the market via different routes. Azeris and Armenians demonstrated surprising levels of trust for two countries at war, without the fall-back of formal laws or contracts. In the words of one Azeri middleman who supplied goods on credit to Armenian customers, "we all know each other and reputation is our major asset." However, in April 2006, the Georgian authorities decided to close the market, terminating the only place where direct trade contacts between Armenians and Azeris occurred.

The 'Arizona' market that sprang up in the Brcko border district between Bosnia & Herzogovina (BiH) and Republika Srpska following the Balkans war has emerged as a major centre for regional trade, bringing together traders from Bosnia, Croatia, and Serbia. Despite concerns about criminality and tax evasions, the Office of the High Representative decided to keep the market open—while closing down all other informal markets in BiH—viewing it as a source of livelihoods and a 'neutral space' for economic interactions between the three economic groups. Recent reforms have formalized the market, with an Italian investor winning the tender to finance, design, construct, and manage the market for 20 years, accompanied by concerted law enforcement action to suppress criminal activities. The market today employs around 5,000 people, with different ethnic groups living side by side and earning the highest average wages in BiH.

Source: International Alert (2006).

1997. The council aims to promote dialogue and reconciliation between two countries that lack diplomatic, official or economic ties, by demonstrating the benefits of direct co-operation between each country's private sector. Joint activities have included lobbying both governments for the restoration of transport links.[32] Another example is in Burundi where the *Dushirehamwe* networks of Hutu and Tutsi women, which started as a community-level dialogue focused on conflict resolution, soon evolved to include joint economic activities. Organizers realized that reconciliation would be incomplete without addressing the urgent problems of securing livelihoods, and so established farming cooperatives, achieving economies of scale through the joint production and sale of agricultural products. In the words of one organizer, "the various economic activities carried out by different groups serve shared interests and reinforce the cohesion between different ethnic groups."[33]

Private sector activity can also build social capital at the institutional level. Co-operation between private sector participants may lead to the (re)establishment of business associations that subsequently engage in dialogue with government to improve the business environment. Business associations can provide checks and balances on governmental actions, act as a conduit for criticism, and lobby for the improvement of important institutions such as systems for resolving commercial contract disputes.[34] The growth of the private sector may also provide incentives for

[32] Schwartz, Hahn and Bannon 2004.
[33] Schwartz, Hahn and Bannon 2004.
[34] At the same time, private sector actors can sometimes play a destabilizing role. In a weak regulatory environment, firms may help embed corrupt practices through bribery. They can undermine the establishment of an effective law

the government to develop its own institutions, such as revenue collection agencies and enterprise support agencies.[35]

It is also worth noting that the private sector has often been directly involved in peace-building efforts, both in the conclusion of peace agreements and in the post-conflict phase. In some cases, they are involved as ‘insiders,’ taking part in negotiation teams. In others, they are ‘outsiders,’ playing a catalytic role by building trust between parties and providing logistical and administrative support.[36] For example, in El Salvador, the private sector played a significant role as an interlocutor in the negotiations that led to the peace agreement of 1992, helping shape the design of the talks and assisting in the implementation of the final agreement.

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enforcement system through use of private security agents (particularly if these are ex-combatants). Private interests may even directly contribute to political fragility through their activities, as in the case of arms sales. In the Democratic Republic of Congo, a recent report notes that local entrepreneurs in Goma maintained close ties with rebel forces, occasionally encouraging armed operations against rival operators. In other contexts, such as in Latin America, the structural position in society of the formal private sector is arguably an important factor in fomenting and sustaining conflict, particularly in situations where a small private sector elite was viewed as being on one side of a deep socio-economic divide. See International Alert 2006.

[35] DFID 2005.

[36] International Alert 2006.

4) IMPROVING THE INVESTMENT CLIMATE IN POST-CONFLICT SITUATIONS: LESSONS FOR DEVELOPMENT PARTNERS

The previous section argued that the contribution of the private sector in post-conflict situations goes beyond the traditional role of the private sector in boosting economic growth and creating jobs and wealth. By providing the capacity to deliver public services and by helping build social capital, the private sector can help address both ‘greed’ and ‘grievance,’ cementing the peace and reducing the likelihood of a return to conflict.

Yet the experience to date is that the PSD policy agenda tends not to be systematically prioritized and integrated into post-conflict reconstruction efforts. While, as with all development co-operation efforts, success or failure ultimately depends on the capacity and inclination of the country authorities, there are lessons to be learnt by development partners on what we can do to support efforts to improve the investment climate in the post-conflict phase.

There are two primary ways in which development partners can assist efforts to improve the investment climate following conflict: analytical and advisory support for developing a new policy framework, and support for the process of prioritizing and implementing those policies. This section focuses on the latter. It looks at several issues for development partners to consider in this area:

- Integrating the investment climate into first-round reforms
- Generating ownership and enhancing capacity
- Developing partnerships between public and private sectors
- Appropriate reform trade-offs and sequencing
- Ensuring development partner interventions do no harm

Integrating the Investment Climate into First-Round Reforms

Given the valuable dividends that a strong investment climate pays in a post-conflict situation, investment climate reform has to be a top priority in the initial round of policy-making. This is for two principal reasons. First, from a political economy perspective, the threat of a relapse into conflict[37] creates a sense of urgency in generating jobs, delivering public services, and re-building social capital. Second, from a process perspective, there is a need to take advantage of the reform momentum in the post-conflict phase. There is typically a new government team, with an appetite for novel approaches and the energy to push a change agenda. This window of opportunity can rapidly close, however. Pushing through PSD-friendly policies in a “second generation” of post-conflict policy reform can be more difficult, as the overall policy orientation is likely to have been largely set and new vested interests may have already emerged.

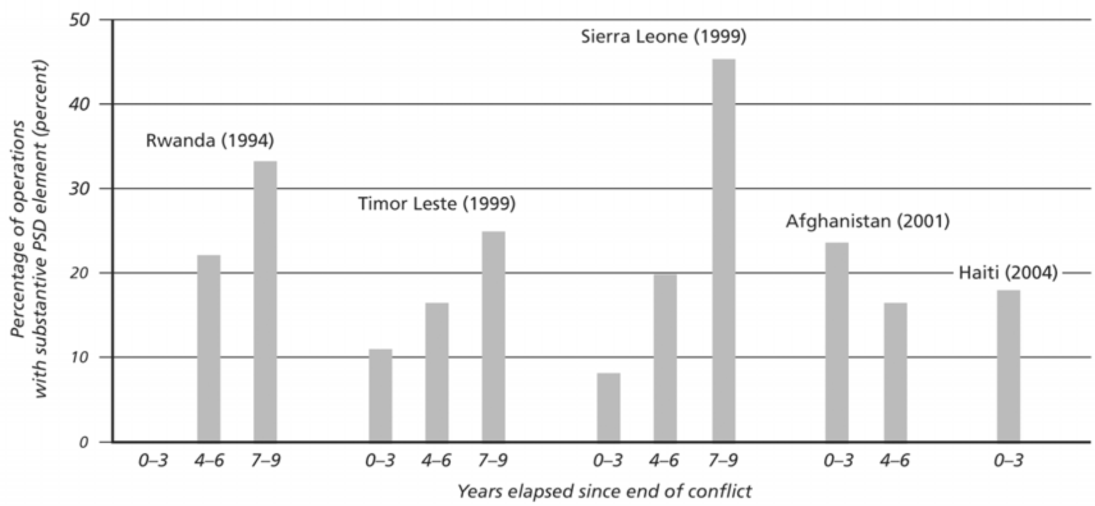
But in practice, reforms to kick-start private sector activity have traditionally been crowded out in the ‘first generation’ of post-conflict reforms, rather than being systematically integrated into post-war planning. The emphasis instead has tended to be on rapidly restoring macro-stability and some

[37] Typically, half of all civil wars are relapses into conflict during the first decade of peace following a previous conflict. See Collier 2004.

degree of administrative functioning (such as for handling emergency reconstruction contracts). Development partners have in many cases embarked on extensive civil service reform programs, re-establishing and reforming public administrative agencies and setting up large-scale training programs. While the functions of many of the civil servants trained have a direct impact on private sector activity (particularly customs and tax staff), the importance of an investment-climate friendly approach has often not been integrated into the reform programs.

In an attempt to quantify the degree to which the PSD agenda has been neglected in post-conflict interventions by development partners, we have analyzed World Bank Group financial operations[38] in a group of five countries that have emerged from conflict at various points over the last decade (see figure 2). The aim is to identify operations that either directly supported private sector development (such as a microfinance project), or which supported the private sector enabling environment (including those budget support interventions that had PSD as a prominent policy objective).[39,40] The approach was to calculate the number of operations that included a PSD element by this definition, as a percentage of all WBG financial operations in the country. We did this for the initial three year period following conflict, and compared it to subsequent three year periods. The five countries analyzed were Rwanda, Timor-Leste, Sierra Leone, Afghanistan, and Haiti.

Figure 2. PSD focus in WBG financial operations in post-conflict countries



Source: World Bank Project Portal. Dates in brackets are for year when major conflict ended. See text for methological caveats.

[38] In addition to financial operations, there have been extensive analytical & advisory activities (AAA), technical assistance and capacity-building interventions in these countries. These important activities are harder to quantify. Inevitably, financial operations reflect only part of the picture.

[39] In several post-conflict countries, emergency credits that constitute de facto budget support have been provided in support of overarching recovery strategies.

[40] This approach is necessarily subjective. For example, we have counted power sector operations as being supportive of PSD, because energy access is an important constraint on private sector activity, but have not counted water sector operations, which are a less important input. The tally of operations that support the PSD agenda also includes activities aimed at drawing in foreign investment (for example, in natural resources sectors), interventions that were initiated but then dropped and projects that have been initiated but not yet taken to the World Bank Board of Directors for approval.

There are two principal insights from the analysis:

- The pattern of WBG financial interventions appears to support anecdotal observations that PSD interventions have tended to only occur in a second round of reforms, several years after initial stabilization has occurred. In Rwanda, Timor Leste and Sierra Leone, PSD or PSD-relevant interventions were relatively few in number in the first three years following conflict. In subsequent years, PSD became increasingly mainstreamed in Bank activities, with well over 20 percent of projects having some connection to or support for PSD in the period of 7–9 years after conflict. In the case of Sierra Leone, nearly half of WBG financial operations occurring seven years or more after the end of the conflict can be classified as having a PSD-supportive element.
- It also suggests that in the more recent post-conflict cases—namely Afghanistan and Haiti—lessons have been learned. In both of these cases, the PSD agenda has been relatively more prominent from the outset of resumed Bank operations.

There are a number of reasons for the lack of integration of the PSD agenda into the broader post-conflict reconstruction agenda.[41] First, some PSD issues—such as land reform - can be politically difficult in a post-conflict environment. As noted above, the deterioration in governance during conflict creates rent-seeking vested interests. PSD reforms can threaten these rent-seeking systems, which are consequently stiffly resisted. Second, PSD policy can require re-thinking the role of the state in the economy, which can be seen as a secondary priority to re-establishing the machinery of government in a post-conflict situation. Third, the development partner community is fragmented, with some agencies lacking either a mandate or expertise to promote PSD in the post-conflict period.[42]

Box 6. Reform in Rwanda: the benefits of prioritizing PSD

Post-conflict policies in Rwanda helped to bring about macroeconomic stability within 3 years—an important achievement. However, economic growth performance in the post-conflict period was mixed: the informal sector (including the agricultural sector and services) recovered relatively rapidly, but growth in formal sector activity (agribusiness, domestic trade and manufacturing) was relatively weak. As a result, real growth rates in the 1994–2000 period were modest, averaging around 3–4 percent per year.

Rwanda's second generation of post-conflict reforms was PSD-oriented and supported by development partners. The new policy framework, instituted progressively since 2001, is friendlier towards both domestic and foreign investors. Reforms have included revising the entire legal framework to make it more investment-oriented. The tax code was revised and rationalized, eliminating discretion and fundamental land reform was undertaken, including the creation of a titling system. Formal sector economic activity has grown at 6–7% in real terms during 2003 and 2004. Other indicators have also shown an uptick in private sector activity: for example, domestic business registrations have increased at a rate of 10 percent per year in the 2001–04 period.

Source: Stern (2005).

[41] Stern 2005.

[42] For example, DDR programs for ex-combatants are often run by UN agencies that are not necessarily mandated to assess the impact of their programs on labor markets and private sector job creation.

Generating Ownership and Enhancing Capacity

In order to ensure ownership of the policy agenda, any external inputs must closely support the government's own efforts. This will increase the likelihood of commitment to and continuation of reforms. An investment climate reform framework that is simply parachuted in from above risks rejection by the country authorities. It also risks bypassing and hence undermining nascent governmental capacity.

Ensuring government ownership is easier said than done. Investment climate reform, like any reform process, is embedded in a political context. Development partners must be sensitive to post-conflict political realities, both in terms of possible vested interests of the principal stakeholders (not all of whom stand to gain from reforms that free up private sector activity) and to the risks of pushing reforms that have unintended consequences.

Sensitivity to post-conflict political realities—particularly when the political economy context is complex—can be fostered through dialogue and other consultative measures to ensure that PSD reforms have the intended effects. It is vital to identify all relevant stakeholders, including private sector representatives and civil society leaders, to ensure they are included in the reconciliation and reconstruction processes.[43] It is also necessary to have a frank view of 'who is who': to gauge ex-ante who stands to gain and who stands to lose from a particular PSD reform path. In some cases, this may mean actively seeking stakeholders as counterweights to vested interests who seek to block the emergence of a vibrant and competitive private sector.

Even the best policy framework will come to naught if the government's capacity to implement is weak. Given that capacity is severely degraded in most post-conflict situations, implementation capacity must be developed side-by-side with policy reforms. Yet development partners have, to date, placed relatively little emphasis on enhancing implementation capacity for investment climate reforms. This is an area that needs greater commitment from development partners, at an earlier stage of the post-conflict phase.

Box 7. Unintended consequences in the Democratic Republic of Congo

The extensive literature on 'conflict economies' has underlined the role that certain economic sectors—particularly extractive industries—can have in triggering conflict. Post-conflict reforms that attempt to re-start activity in these same sectors can mean re-engaging the same actors and processes that stoked the conflict. In the Democratic Republic of Congo, for example, one view is that post-conflict legal reforms actually facilitated the diversion of timber revenues away from the authorities and that the privatization of state-owned companies was largely to the benefit of business interests closely linked to parties involved in the conflict. Thus, both reforms were politically destabilizing, further weakening the investment climate rather than strengthening it.

Source: Taylor (2003).

[43] DFID 2005.

Unlike reform processes in other areas, supporting a PSD agenda means enhancing capacity in both the public and private sectors. The nature of capacity development in the two sectors differs. Interventions aimed at the private sector need to focus on awareness-raising, which might include disseminating information on new opportunities and resources available to enterprises—such as microfinance for SMEs—in order to encourage private sector activity. Policies that will be implemented via government agencies—such as a land survey in support of a land titling program—need to incorporate training and capacity upgrading components as a matter of course.

Developing Partnerships between Public and Private Sectors

Public-private dialogue and partnerships are a vital component of efforts to re-build trust and collaboration between the public and private sectors, and need to be initiated from the outset of post-conflict reconstruction. Business owners are better placed than governments or donors to know what improvements in the investment climate are needed. They can also contribute their own resources, such as time and research. Their involvement will both accelerate policy reform and ensure that it is on the right track.[44] By bringing the issues out into the open for public discussion, public-private dialogue also helps minimize back-room deals involving a select few.[45] In Cambodia, for example, bi-annual meetings of the Government–Private Sector Forum generate discussion on a range of investment climate issues. Cabinet level participation from the government side, including the chairmanship of the Prime Minister, means that decisions made in the Forum are binding. Dialogue is most effective when it focuses on economic reconstruction and investment climate improvement, especially the need for job creation, as this helps to avoid the risk of politicization.[46] Dialogue on how to share resources and build capacity is particularly important.

Box 8. Public-private partnership in Bosnia & Herzegovina: The 'Bulldozer Initiative'

In post-conflict Bosnia and Herzegovina, an innovative reform methodology relied on grassroots business participation to push forward a reform agenda. Using a bottom-up approach that relied on raising public awareness of weaknesses in the business environment, the initiative mobilized the local business community to "bulldoze" regulatory barriers to doing business by identifying concrete legislative changes and advocating for their adoption and implementation.

By emphasizing fast results, the initiative won the confidence of entrepreneurs who then established permanent grassroots reform committees. Reforms proposed by these committees spanned all sectors of the economy, including enterprise law, banking and finance, tax, exports, trade, labor, and the environment. Each proposal was evaluated by a group of lawyers and economists and subjected to a cost/benefit analysis, with industry experts were invited to comment on ideas before they were taken to the next stage.

Source: Herzberg (2004).

[44] Curtis 2006.

[45] See DFID et al. 2006. The dialogue needs to bring in recognized representatives of the business community, avoiding any risk of cronyism.

[46] Bannock Consulting 2005.

Box 9. Diaspora investment in Afghanistan

A high-profile example of diaspora investment in a post-conflict setting is in the mobile telecoms sector in Afghanistan. Approximately $75 million was invested in the new Afghan Wireless Communication Company (AWCC), which is 80 percent owned by Telecommunications Systems International, a company founded by an Afghan diaspora entrepreneur based in the United States.

AWCC is one of the two initial mobile phone operators in Afghanistan. Since inaugurating GSM services in Kabul in April 2002, AWCC has grown to 90,000 subscribers and 800 employees, and has deployed operations in Herat, Mazar-i-sharif and Kandahar. Traffic on the network has quickly exceeded all expectations.

Source: International Alert (2006).

The diaspora can be an important partner in reconstruction. Diaspora communities are often committed to rebuilding their country and can contribute expertise and funds (both through remittances and direct investment). Their knowledge of both the local economy and the political economy means that they are often prepared to invest in small to medium enterprises that are either off the radar screen of foreign investors or deemed too risky. Their activities can also galvanize local private sector activity, either through increasing market contestability or through their demand for local goods and services inputs into their businesses.[47]

Development partners have an important role to play in this area. They can encourage the conditions needed for dialogue, as well as catalyzing, supporting and facilitating the dialogue itself. An "honest broker" may be needed in some situations, and this is an area where development partners have something important to offer, either in facilitating dialogue directly, or in helping to identify a suitable facilitator. Development partners may also be well-placed to catalyze diaspora involvement. At the same time, any external inputs must not come at the expense of local ownership: external actors need to know when to disengage.

Appropriate Reform Trade-Offs and Sequencing

Investment climate reforms, as with any other reforms, do not come as a coherent package. Tough policy choices need to be made, with close attention paid to trade-offs and sequencing. One of the first trade-offs to be addressed is the extent to which the policy framework that shaped the investment climate before conflict should be re-adopted.

One perspective is that the post-conflict period presents a unique opportunity for institutional, policy and management innovations that may not have been possible in the pre-conflict period. The post-conflict period represents a window of opportunity for reforms that might otherwise be highly disruptive of the business environment. For example, the opportunity can be used to

[47] However, it is important to note that the diaspora's contribution can be affected by the political context. The very existence of a significant diaspora can sometimes be linked to political disputes in the home country, as well as being a significant factor in the causes of conflict. This implies that the nature of diaspora involvement depends on the conflict's outcome.

overhaul the regulatory framework for business by creating an integrated and transparent business registration and tax system that provides incentives for firms to formalize. Or the post-conflict phase could be used for wider-ranging reform of contracts and working practices for public servants so that the space for discretionary or rent-seeking behavior is minimized.

Yet governments in post-conflict situations have to walk a fine line: they need to ensure that the first generation of reforms are PSD-friendly and take advantage of the opportunity to innovate, while not developing overly ambitious plans that may be risky, hard to implement and delay the re-starting of government services. This implies establishing and communicating a limited timeframe to develop new policies, so that private sector actors' expectations can be set accordingly. Well-coordinated development partner support can be very important in this difficult transition period.

Similarly, it is important that reforms are carefully sequenced. Fledging post-conflict governments may face the temptation to over-regulate in an attempt to establish control and legitimacy. Even if the capacity to implement business rules and regulations is limited, firms will still be provided incentives to maintain a low profile by remaining in the informal sector. Efforts to coax informal firms into the formal sector needs to be implemented over a medium to long term time horizon and combine regulatory sticks with sufficient carrots.

In situations where significant policy and institutional reforms are being undertaken, it can also be useful to deliver 'quick wins' that buy time and build confidence in the government's commitment to reform.[48] Quick win reforms tend to be 'stroke of pen' interventions that simplify the business environment—such as the company registration process—but which do not require extensive implementation capacity or the dismantling of entrenched vested interests. As a government builds credibility and political capital, it is then better positioned to take on tougher PSD challenges.

Privatization is a politically sensitive issue that also requires careful attention to sequencing. A post-conflict environment does not *per se* change the analytical rationale for privatization reforms, but the social and political context must be taken into account. Privatization that proceeds too quickly in a post-conflict environment that lacks sufficient regulatory and enforcement capacity risks negative side-effects, particularly relating to anti-competitive practices and a compounding of the unemployment problem. Privatization reforms, if and when appropriate, are best undertaken in gradual steps, including a progression from modest forms of private participation in infrastructure and public service delivery (for example, service or management contracts) to deeper forms, such as leases or long-term concessions.[49] The political economy of the privatization process—for example, who controls it and who stands to gain from it—needs also to be carefully considered. It is important to build a constituency for reform and to ensure that privatized assets do not fall into the hands of a small group of well-connected investors, particularly those who are seen to have benefited from conflict. Government can also encourage the development of small-scale private service providers or, at the very least, refrain from regulating them out of existence.

[48] Curtis 2006.
[49] Schwartz, Hahn and Bannon 2004.

Ensuring Development Partner Interventions Do No Harm

Last but not least, development partners need to be aware of the possible negative consequences for the investment climate of their presence and activities in post-conflict zones. Aid, accompanied by aid workers, often flows rapidly into post-conflict countries. The influx of aid itself can cause an appreciation of the real exchange rate to the detriment of exporters, compounding the disruptions in market access caused by conflict.[50] Post-conflict aid may generate inflationary pressures and localized economic distortions as expatriates purchase goods and services. In post-conflict Cambodia, for example, there was a rapid escalation of certain consumer prices and a large increase in restaurant and house rental costs. [51] While a boon for some, private sector actors not involved in supplying the expatriate market may be crowded out or face higher input costs. The aid industry can also lead to higher labor costs. With aid agencies hiring interpreters, drivers, and local 'fixers' from a small pool of skilled local labor, at prices much higher than government agencies or the local private sector can afford, the development of a sustainable local private sector or high-quality capacity within the civil service may be undermined. As one report puts it, "a judge is working as a driver or an electrical engineer as a security guard."[52]

Reconstruction efforts funded by development partners can also have unintended consequences for the local economy. In the political haste to see rapid gains on the ground following conflict, large reconstruction contracts are usually awarded to foreign companies with a prior track record. The local private sector largely misses out, as it is has minimal links to donor agencies and is often viewed as being incapable of undertaking large contracts. Local firms are often confined to the role of sub-contractor. However, as a recent case study on Afghanistan shows, sub-contracting often means that much of the work is still done by local firms, but with a major cut to their profit margins.[53] As a result, the economic benefits of reconstruction are reduced as profits are expatriated rather than re-invested, growth and expansion opportunities for local firms are foregone and local businesses miss out on opportunities to acquire valuable experience. Development partners need to ensure that the local private sector is more fully integrated into the post-conflict reconstruction process.

[50] Schwartz, Hahn and Bannon 2004.
[51] Carnahan 2005
[52] Quoted in Carnahan 2005.
[53] International Alert 2006.

5) CONCLUSIONS

Conflict has a deeply negative impact on the investment climate. The list of investment climate policy issues affected is a long one, ranging from macroeconomic stability to the regulatory framework. The implication of this for governments and development partners is that efforts to improve the investment climate following conflict need to be similarly comprehensive: any one of these policy issues has the potential to be a binding constraint. This calls for shrewd policymaking: sequencing is important and trade-offs need to be made. While 'quick wins' are important for establishing the credibility of a new government team, care needs to be taken not to overload the policy agenda.

The febrile environment in post-conflict situations affects investment climate reform efforts. Even more so than in non-conflict situations, policymakers need to be sensitive to the broader 'enabling environment.' The quality of institutions and governance; the intricacies of the political economy; the capacity to implement reforms; the extent to which social capital has been depleted: these all matter. They are critical in determining whether otherwise sound policy reforms gain traction. Addressing these issues requires delicate footwork, including the fostering of dialogue between the full range of stakeholders early in the reform process, in order to ensure broad ownership of the plans to rebuild a strong investment climate. As a consequence, in addition to their traditional roles as policy advisers and financial backers for the private sector agenda, development partners need to be able to take on new roles as facilitators, 'honest brokers' and implementation supporters. At the same time, development partners need to be aware that they can have a heavy 'footprint' in fragile post-conflict economies. They need to be careful to minimize distortions to the local economy that undermine the very private sector they are trying to support.

Despite these complexities and potential pitfalls, the case for a strong investment climate and a vibrant private sector in post-conflict zones is compelling. The private sector plays three vital roles: it generates employment, it provides public services where the state has retrenched and it builds social capital. By addressing these important 'greed and grievance' factors, the private sector helps cement the peace and reduce the likelihood of a return to conflict. Despite this, investment climate and PSD reforms have been largely crowded out of the first round of post-conflict reforms. Putting them back on the table in a second round of reforms can be difficult, as vested interests emerge and the enthusiasm for further reform wanes. While there is some evidence to suggest that the PSD agenda has received greater attention in recent post-conflict situations, more needs to be done to ensure that kick-starting the private sector is an immediate priority following conflict.

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