Private Investment and the Role of the State in Reconstruction

International Conference on “Private Sector Development and Peacebuilding - Exploring Local and International Perspectives”

Berlin, 14 September 2006

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Good Morning, ladies and gentlemen!
I would like to thank the organizers for inviting me to speak today. This is a fascinating conference, dedicated to an important but long neglected theme.
I would just like to add to the kind introduction that I am also a co-director of the Households in Conflict Network. The network was established earlier this year by a group of economists - including myself - who felt that there was an important gap in the analysis of conflict and post-conflict reconstruction. This gap in our understanding of conflict concerns the welfare and the behaviour of individuals, households, firms and groups - that is the micro-level dimensions of conflict.

Too long has economic research and policy analysis remained at the cross-country or the country-level. Much can be learned by crunching aggregate data or by the qualitative inspection of country evidence. In fact, much of the evidence presented later today and tomorrow is derived from such country case studies.
However, there is a strong need to delve deeper into conflict-affected economies, to understand the individual rationale for conflict initiation and conflict coping, to evaluate at the level of the household or the firm how well we have assisted the recovery process.
Before starting with the main theme of my presentation, I would therefore like to stress the importance of considering the right unit of analysis, of bearing in mind the people and the actors behind what we analyse, of making sure we fit our analysis into a framework that is compatible with individual and group incentives, constraints and actions.
I have been asked to share with you some thoughts on the role of the state in post-war reconstruction and how the state can contribute to private-sector led investment and development in post-conflict environments.
Naturally, much of what I will say on the issue of the state does not deal with households or firms. However, I will return to this theme at the end of my brief talk to explain how such a focus on the individual agent may help advance our future understanding of conflict and reconstruction.
Key Message
I would like to start by summarising my main argument before providing you with a framework for analysing the role of the state in post-war reconstruction.

We could summarize the emergence of a new policy agenda in post-war reconstruction as follows:

- post-conflict reconstruction requires growth
- growth requires private-sector investment
- investment requires an effective state
- an effective state requires overcoming the war legacy
- overcoming the war legacy requires the active participation by individuals in their societies

Therefore, we need to jointly consider three dimensions of reconstruction: peace, prosperity and participation.

This policy agenda is more demanding and challenging than what we were faced with before the end of the cold war. We therefore have to make some tough choices on the way.

In short, I will argue that: Reconstruction should not imply that we focus only on narrowly defined war activities (such as blood diamonds or money laundering). Instead, we should adopt a broader approach to post-war reconstruction (also considering the role of other private sector agents like farmers or traders and hence broader issues like justice, legitimacy and equality).

Peace, Participation and Prosperity
Political participation is a key factor for successful post-conflict transition.

Political participation has many dimensions such as constitutional design, electoral politics, human rights protection, the legal and justice system, decentralisation, accountability, and political culture. Political participation can occur at the individual or the institutional level and may vary across groups within a country. It is hence a much broader concept than national democracy as represented by national parliamentary elections, which is the element of participation most focused on by the media and by many donors.

Unfortunately, the economic pre-requisites for participation, for stable democracy, are still largely unknown. In fact, the triangular causal relationships between peace (or conflict), prosperity (or growth or poverty reduction), and participation (or democracy) are not yet very well understood.

For example, the absence of conflict should help to establish participation but participation may not necessarily lead to peace in a linear fashion. In addition, peace may be a necessary but not a sufficient condition for early democratisation.

Interestingly, democratisation may lead to conflict - for a variety of reasons. With an intermediate number of political groups, politics may become very divisive, for example by emphasising ethnic or religious divisions. Furthermore, the political changes implemented to achieve more democracy (or simply the economic development process itself) could trigger violence which, ironically, may prevent the attainment of democracy. In other words, the attraction of the first best outcome may make the second best outcome unobtainable. Therefore, fragile democracies may be the worst form of state governance for preventing conflict.

However, there is a large degree of variation of experience across countries and across time. A number of positive experiences of peace and participation may help guide
policy makers on how to avoid a conflict-ridden path to participation. Mozambique, Botswana and India may all serve as evidence that stable democracy can be attained for low income countries, even if each of these countries has had mixed experiences of participation and peace.

The cautious message is that peace, prosperity and participation may be mutually reinforcing, even if we do not yet know very well how these processes function.

State and Justice

Justice is a crucial theme in any post-conflict society. Justice encompasses order and security, political justice, reconciliation and social justice. Justice is in fact one of the cross-cutting themes of the reconstruction debate, linking together peace, prosperity and participation.

Justice may be an issue at the sectoral, local or individual level, shaping incentives and identities, and hence peace, prosperity and participation.

Hence, justice can provide a framework for the choices that have to be made during this transition. The peace settlements of Guatemala, Liberia, South Africa or Afghanistan, to name but a few, each aimed to do justice in some parts of society or the economy, while perpetuating obvious injustices in other fields.

Given the role of injustice in motivating or enabling conflict, justice has to be considered explicitly in the post-conflict context. This is a dynamic process. In fact, justice is one of the longest lasting projects in post-war reconstruction. It cannot be attained by focussing on growth or security or democracy alone.

In summary, without some consideration for justice as a cross-cutting theme, there cannot be an effective state, there cannot be positive expectations and certainty, there cannot be strong growth in private-sector investment, and hence there cannot be sustainable post-war reconstruction.

State Legitimacy

State legitimacy is typically shaken - or even directly attacked - by civil or even international war. Hence it is paramount to address and resolve state legitimacy to overcome conflict.

Arguably state legitimacy has to be established before issues of justice can be addressed by the state. Social and distributive justice in particular cannot be achieved if the state continues to be seen as illegitimate.

The forms of grievances (domestic or international), the forms of interventions (external or internal, diplomatic or armed) and the nature of the justification for the interventions (moral or military, unilateral or multilateral) may hence cast a strong shadow on the entire post-conflict transition period.

Even in countries with formal, supervised peace agreements, such as Mozambique or Guatemala, questioned legitimacy of the state may continue to prolong the period of post-conflict uncertainty and thus slow down investment and reconstruction.

In contrast, countries without a sovereign government such as pre-independence East Timor or Kosovo may in effect be governed by the United Nations like a neo-colonial regime - yet these regimes may enjoy a degree of legitimacy unknown of in Iraq or Darfur.

Sometimes, legitimacy and hence the option of building justice may best be served by successful reconstruction policies. In other words, building state legitimacy may be one entrance into a virtuous cycle of peace, prosperity and participation.
**State and Equality**

Group equality and equality dynamics matter for the long-term resolution of violent conflict.

This requires an understanding of and a commitment to the solving of structural imbalances in a society. In other words, we must also be interested in the distributive dimension of justice. Otherwise, between-group and within-group inequalities may cause a resumption of conflict - even with otherwise favourable macro-economic indicators.

Research has started to identify persistent patterns of inequality in causing and shaping conflict - and vice versa. Meanwhile, it appears that the policy community is lagging behind somewhat in applying these insights. The low level of understanding of detailed conflict dynamics prevents policy makers from integrating group inequality considerations into their programming.

Given that the normal economic policy package of liberalization and market forces is not generally sufficient to reduce group inequalities - or may even exacerbate them - new policy approaches are required. Improving processes, rather than quotas or other quick fixes, appears most suited for a reduction of group inequalities in post-conflict settings.

Furthermore, group inequalities are an expression of the deep causes of economic underdevelopment, thus indicating that overcoming such inequalities will require profound structural reform. Certainly, overcoming entrenched group inequalities may not necessarily be Pareto-optimal, calling for policies which will challenge entrenched rights and privileges.

**Conflict and Globalisation**

Globalisation has changed the nature of post-conflict reconstruction.

Overcoming war today requires different approaches than it did in the past. Many development prescriptions that seemed promising in the past are no longer available in times of accelerating globalisation and technological change. Overcoming war by turning to import-substitution simply is not an option for African countries today, even if South Korea may have used that model to overcome its war half a century ago.

Today’s conflict economies - one way or another - are well integrated into the world economy, despite the high transaction costs that conflict imposes on economic activity. These linkages occur through financial, labour and product markets and through aid.

The increased globalisation even of war economies has some positive and some negative consequences.

On the positive side, it raises the chance for interventions, for example through sanctions or aid, or by raising the returns to peace.

On the negative sides, it also increases the gap between an underdeveloped war economy and its peaceful peers. Globalisation also enhances the scope for criminal activity to finance war, to profit from war and to finance other illegal activities such as global terrorism.

Most importantly, globalisation reduces the incentives for foreign investors to claim conflict-affected markets, with so many alternative investment prospects competing for their attention elsewhere in the world. This is a constraint that policy makers have to account for more than ever before - even in conflict settings.
Evidence
There is some empirical evidence for the framework that I have just sketched and - I am sure - some more evidence will be presented in the next two days.

New and different policy choices are made by international organisation like the IMF in providing advice to conflict economies, for example in the field of post-conflict fiscal policy, which is an important determinant of private sector opportunities.

Donors are reconsidering their programmes - balancing complexity with simplicity - for example by recognising that the literal re-construction of infrastructure hardware is not sufficient for a successful post-war transition - but that this requires also a strong commitment to the software of infrastructure development and to the processes of development - thus benefiting the investors in infrastructure rehabilitation and the private sectors users of that infrastructure alike.

Sector-wide approaches in conflict-affected economies are becoming more common and open new venues - for example in the field of post-conflict health care provision, where humanitarian operations are designed with a development impact in mind, combining the strengths of civil, private and state operators of health care.

Research
On the research side, much more needs to be done to understand how both conflict and donors impact on individual agents, including the firm.

Also there is precious little data at the individual, household or firm level to understand how actors - including small entrepreneurs or small-scale farmers - cope with war and peace. This requires new surveys, new questions, new enumeration techniques and new commitment by donors to fund and to listen to this type of research.

Furthermore, what is still missing from this debate is a systemic and scientific evaluation of policies in the conflict setting - for example by randomizing donor assistance within post-conflict microfinance projects.

If you are a donor interested in conducting such research, please let me know!!

Summary
In summary, I argue that we must analyse and address the three related dimensions of reconstruction: peace, prosperity and participation. This policy agenda is more demanding and more challenging than what we are used to from the cold war. We thus have to make some tough choices on the way.

I suggest that reconstruction does not imply we should focus on war activities (like blood diamonds). Instead, we should adopt a broader view of the state in post-war reconstruction (by also considering issues like justice, legitimacy and equality).

In short, I believe that good reconstruction policies are good development policies (but that the reverse may not always hold).

Thank you for your attention. I look forward to a lively debate.