



Policy Brief

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Overview

Economic development is essential for every country but it is especially crucial for those countries in the aftermath of protracted armed conflict, needing peacebuilding, recovery and reconstruction. Development aid alone cannot transform damaged economies, and it is here that foreign direct investment (FDI) can be a valuable tool to revitalize industries, rebuild infrastructures and eventually even eliminate the need for aid.

Regard for history, economic experiences, local cultures and tensions should inform the adoption of a post-conflict private investment regime that is specifically tailored to the country's needs. Encouraging a form of FDI that benefits post-conflict zones relies upon prioritizing quality of investment, rather than quantity. The task of developing countries, and particularly those emerging from years of conflict, cannot be left solely to market forces – FDI can only be justified if it is high value and makes a real contribution to the host economy, in terms of job-creation and spill-over of knowledge or technology.

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Post-Conflict Countries and Foreign Investment

IT HAS BECOME INCREASINGLY CLEAR THAT ECONOMIC development and poverty reduction can significantly reduce the incidence of conflict. This is of particular importance for countries recovering from violent conflicts, considering they are often among the poorest even compared with other developing countries, and are extremely vulnerable to slipping back into violence.

Economic development therefore plays a key and interrelated role – along with political development and the maintenance of security – in post-conflict peacebuilding processes aimed at creating lasting and sustainable peace. Clearly, the needs of post-conflict transition countries vary according to their situations. The overriding priority in those countries emerging from complete collapse such as Liberia and Somalia is to restore stability and security. Where institutions are still intact to some degree, efforts can concentrate more on improving economic and social conditions by establishing effective, accountable governance mechanisms.

In addition to the omnipresent threat of relapse to violence, post-conflict countries are afflicted by a range of other serious risks and capacity deficits, including political instability, severe security problems and a lack of institutional capacity. In developing countries generally, and even more so in post-conflict countries, weak institutions are known to hamper entrepreneurial investments, exacerbating underdevelopment. Physical infrastructure is often damaged or unavailable, including electricity, water, transport and access to land. Corruption is often endemic, while transparency and the rule of law are either absent or extremely weak. These are all strong limiting factors on economies shattered by conflict, and deprived of skilled labour as they struggle to cope with the effects of brain drain and capital flight.

Accordingly, the challenges of post-conflict economies are very different to those of developed, and even of other developing economies.

Development and Foreign Investment

Within the post-conflict recovery process, reconstruction and development of physical and institutional infrastructure are essential goals. The two main sources

of such development are foreign aid and foreign direct investment (FDI), with least-developed countries the most reliant upon aid among all developing countries, and the most lacking in FDI. Many post-conflict countries fall into this category, desperately needing

post-conflict countries slipping back into violence.

Effects of FDI

When transnational corporations (TNCs) invest in developing countries, they bring new technologies and work-

“Left to its own devices, FDI is unlikely to generate growth or create the internal links necessary for development”

FDI and Economic Growth

The possible existence of a positive relationship between FDI and economic development is a subject of considerable disagreement among scholars and practitioners, with some suggesting that the relationship in fact runs in the opposite direction.

Although the overall amount of investment does not have a significant effect on growth, the quality and form of FDI are seen as important determining factors. It is generally assumed that FDI can bring benefits when carefully managed as part of a comprehensive investment strategy. Investment from abroad brings a direct increase in capital stock and subsequent capital flows, while there is a potential indirect spill-over effect on the host economy, stimulating local spin-off industries and transferring modern technology and new skills.

If realized, this can be a valuable contribution towards achieving the long-term economic and political stability that is desperately needed in post-conflict countries.

increased foreign investment to supplement the flow of aid into the country, revitalize their industries and rebuild their infrastructures. Development aid alone cannot transform damaged economies into vibrant, self-sufficient systems – FDI can bring added advantages, and can eventually even eliminate the need for foreign aid. FDI creates job opportunities which are vital in achieving long-term economic stability. It provides capital to increase the productive capacity of the host economy, and access to international markets, helping countries to move from aid-dependent to investment-driven post-conflict reconstruction. The presence of foreign investment can also provide a form of “peace dividend”, instilling the people with a stronger sense of hope and providing incentives to consolidate peace.

While there is a considerable body of research and lively policy debate regarding FDI's impact in developing countries, assessments of FDI laws and policies have not formed a significant part of peacebuilding research. It is very well established in the war economy literature how “greed” can fuel conflict, but it is not very well known yet how “greed” can fuel peace. There is a pressing need to consider this area with enormous potential for improving social and economic conditions, and in doing so reducing the possibility of

ing practices, along with increased competition. In the short term, competition from TNCs may have negative effects in reducing the market share of local companies. In the long term, however, these companies can gain as they are forced to use their existing technology and resources more efficiently in response to the greater competitive pressure. Local companies can copy the new technology introduced to the country by a TNC, while locals who have been trained in new technology or techniques by TNCs can subsequently set up their own companies or find jobs in other local companies. It is often in the interest of TNCs to provide support and training down the supply chain, improving the productivity of local companies. Improvements in product quality and labour standards may also result from the relatively high standards imposed by TNCs on local firms.

It is important to recognize that FDI can have both positive and negative impacts, which must be carefully considered when designing strategic policy to attract and regulate foreign investment. If FDI is left to its own devices, it is unlikely to generate growth, lead to meaningful technology transfer or create the internal links necessary for development. Any potential contribution by FDI to economic growth of the host country depends

upon creating links with the local economy. Attracting unsuitable or inappropriate forms of FDI risks not only forfeiting potential benefits to the host economy, but can even actively hinder development and visit negative consequences on local communities and on the environment.

Natural Resources

The prevailing conditions in post-conflict countries largely render them attractive only to certain forms of FDI which have limited transformative possibilities. The poorest of poor countries are hardly ever attractive to TNCs in search of markets and profits unless those countries are endowed with abundant natural resources.

It is therefore unsurprising that investments in extractive industries such as oil, diamonds or minerals make up the majority of FDI flows to many developing countries, especially in Africa. Natural resource extraction is primarily export-oriented, with significant potential for income generation but with limited opportunity for employment creation and linkages with the local economy. Such industrial activities also inevitably bring associated negative environmental and social impacts; this phenomenon is prevalent in most of Africa's resource-rich countries, including Angola, Congo-Brazzaville, the Democratic Republic of the Congo (DRC), Gabon, Nigeria, Cameroon, Sudan and Sierra Leone.

More importantly for post-conflict countries, a dependence on natural resource exports has been shown to significantly increase the risk of conflict and damage host-state governance. Countries which are heavily dependent on exporting one resource are also vulnerable to fluctuations in demand, and extraction of any particular resource is an inherently temporary activity – only lasting until the resource is exhausted.

Unfortunately, efforts to implement the Extractive Industries Transparency Initiative, promoted by the World Bank, have been largely unsuccessful because most resource-rich developing countries lack the institutional capacity for such initiatives.

Attracting Beneficial Foreign Investment

Encouraging a form of FDI that benefits post-conflict countries relies upon prioritizing quality of investment, rather than focusing purely on the size of investment flows. FDI can only be justified if it is high value and makes a real contribution to the host economy, in terms of job-creation and spill-over of knowledge or technology. Crucially, any investment regime must recognize that foreign investment is part of economic development within a reconstruction and peacebuilding process, and not an end in itself.

FDI policy must balance these demands with the recognition that developing countries are competing to attract investment. Investors will naturally consider the opportunities, the legal regime and incentives available at various destinations, and decide on that basis where to invest. The investment regime is important not only for attracting new investment – it can also encourage existing investors to re-invest or to increase levels of investment. In addition, it can offer protection and privileges for diasporas to return and assist in the reconstruction of their country.

Clearly, there is no “one-size-fits-all” policy solution for post-conflict investment promotion and regulation. Regard for history, economic experiences, local cultures and tensions should inform the adoption of a post-conflict private investment regime that is specifically tailored to the country's needs. Nevertheless, based on the

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experiences of several post-conflict countries, some provisional conclusions can be drawn, suggesting policy measures to attract and facilitate appropriate forms of FDI, and to maximize the benefits.

Legal Framework for FDI

Violent conflict tends to leave states with a desperate shortage of judicial capacity – many judges and lawyers may have fled or been killed, and unpaid law enforcement officials joined militias. Courthouses, law libraries and other basic infrastructure necessary for a functioning legal system may have been destroyed. For post-conflict states lacking these basic elements of a legal system, it can be impossible to apply, adjust and enforce laws.

This is a powerful deterrent to foreign investors who might otherwise consider making an investment in a post-conflict country. Those that do make investments may require much higher rates of return, given the increased risks of conducting business without effective legal recourse for unlawful actions.

In the immediate aftermath of conflict, establishing a legal framework to attract FDI in post-conflict countries requires enacting legislation, rebuilding courthouses, and training judges and lawyers. This can be all but impossible when faced with tight constraints on financial and human resources and high competition for public spending priority.

Instead, the post-conflict government may “borrow” the laws, infrastructure and expertise of another legal system, including lawyers, judges and arbitrators, as well as courthouses and tribunals. This can be accomplished through investment contracts with individual foreign investors, and through international treaties.

Borrowing Law

Post-conflict governments can enter into individual contractual arrangements with foreign investors, in each case adopting the laws of a foreign state and providing for adjudication of disputes exclusively in their courts. One solution is to designate the courts and laws of the investor’s country as the adjudication forum and governing law of the investment agreement with the post-conflict country. Although this may satisfy investors’ concerns when contracting directly with the government of the post-conflict country, there are legitimate concerns when an investor enters into a joint venture with a corporation of that country. In the event that the government takes regulatory actions which harm the investor, the investor may have neither recourse against the government, which was not a party to the agreement, nor against the corporation, which did not breach its agreement.

International Legal Framework

To address this gap and provide a more complete solution, a post-conflict country can consider additionally adopting the international legal framework for FDI. Unlike some regional or industry-specific frameworks, the framework in question is global in reach and applies to investments generally. A combination of the *International Centre for the Settlement of Investment Disputes* (through the ICSID Convention), the *UN Convention on the Recognition and Enforcement of Arbitral Awards* (New York Convention), and bilateral investment treaties (BITs), permit a post-conflict country and foreign investors to resolve disputes by using neutral arbitrators and to enforce the awards in the courts of any signatory state. ICSID provides a neutral arbitral forum for settling investor-state

disputes, while the New York Convention enforces any international arbitral award between a foreign and a domestic corporation. BITs are designed to promote investment between signatory states, by prescribing that each state will accord substantive protections to the investments from the other state, including protection against direct and indirect expropriation.

A major concern for prospective investors in post-conflict countries is that governments may exercise their sovereign right to change laws, and even withdraw from guarantees of international arbitration at a later date. Investors have a legitimate expectation that the host state will act consistently, and not arbitrarily revoke guarantees – so a provision is needed against future adverse legislative changes on the standing offer to settle disputes by international arbitration. Therefore, it is imperative for post-conflict countries to include a stability clause in their investment codes, specifically granting protection to foreign investors against future adverse legislative changes for a certain period following their investment. Such a stability clause would go a long way in reassuring potential investors of the continued guarantee of dispute settlement by a neutral arbitral tribunal, and thereby encourage them to commit their capital resources in a post-conflict country.

Build, Operate and Transfer

The most beneficial arrangement for those post-conflict countries with abundant natural resources is to persuade TNCs to establish local processing facilities, which can bring the infusion of capital, technology and know-how necessary for sustainable economic growth. This could be achieved through a form of project financing known as Build, Operate and

Transfer (BOT), whereby the government grants concessions to companies to finance and build a particular service or facility, operate it, and subsequently transfer it back to government ownership after the project has paid for itself.

Local processing facilities funded by BOT could allow countries such as Angola and the Democratic Republic of Congo to refine their crude oil for export, while coffee bean producers such as Rwanda could establish flexible facilities with the capacity to roast beans to the specifications of any foreign buyer, and eventually even develop their own national brands for the global marketplace.

Incentives

Tax incentives are one area where it is particularly important to distinguish between investment flows and real contributions to socio-economic development. A major concern is that corporations may invest in a country solely to benefit from the incentives, without making any real contribution to the sustainability of the country's economy. Certain measures, such as the ability of some investors in Rwanda's "free economic zones" to operate at zero percent income tax (with tax-free repatriation of profits), highlight these risks.

Implementing extremely liberal tax policies in pursuit of foreign investment tends to attract a certain form of FDI, entirely motivated by the benefits conferred by a tax haven. In Liberia, taxes are not levied on income earned outside its territorial borders, so TNCs are only subject to taxation for income earned inside the country. In effect, this means foreign investors strive as far as possible to conduct income-generating activities outside the country, with a negative incentive to make beneficial contributions to the host country's economy.

This brief is based on research conducted for the project *FDI in Zones of Conflict*, jointly undertaken by the United Nations University (UNU) and the United Nations Conference on Trade and Development (UNCTAD).

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Tax incentives are often redundant, as in the case of Japanese investments in Indonesia, which continued to grow rapidly even after tax holidays were repealed. Incentives are not only

implemented poorly, or in the wrong situation, privatization brings the disadvantages of monopolization rather than the benefits of free market competition. Privatization should be seen as

“Privatization can bring the disadvantages of monopolization rather than the benefits of free market competition”

a burden on the treasuries of the host countries, but in fact work as reverse subsidies of affluent countries and their investors by poor developing countries. In addition, incentives schemes which grant discretionary powers to administrators often induce corruption, increase costs and discourage serious investors. Where investment promotion agencies are created with the singular aim of increasing investment flows, they will pursue this goal regardless of wider developmental objectives and the costs to society.

For long term investors – who are the most beneficial in development terms – the stability and certainty of the tax regime can be equally as important as the incentives offered. A tax policy with long-term guarantees can effectively attract foreign investors by allaying their concerns, even if the incentives offered are less than those offered by other countries.

Privatization

Privatization is a central element of the neo-liberal economic policies generally advocated for developing countries by international financial institutions. The economic policies of post-conflict countries have often been overly concerned with the investment flows from privatization, without adequately anticipating and mitigating the attendant negative consequences such as down-sizing of labour and price increases. When

one available option within the wider economic development and investment strategy of post-conflict countries – with the choice of whether and how to privatize specific services guided by detailed analysis of socio-economic costs and benefits.

Cautionary Notes

Desperation for investment to provide the capital to fuel a domestic economy can result in policies which focus on investment promotion without adequate regard for the potential impacts of FDI, at the expense of vulnerable peoples and economies. Such policies may crowd out local investment, through offering discriminatory incentives and by providing better legal protections to regional (such as COMESA – the Common Market for Eastern and Southern Africa) and international investors. In addition, aggressive private-sector led development may have negative impacts on the majority of the population, and result in wealth being concentrated in the hands of the very wealthy. Many post-conflict countries have suffered crises with roots in economic grievances, and must be wary of fuelling tensions between different groups by allowing economic inequalities to go unchecked. Indeed, economic policies may not substantially reduce the incidence of conflicts if they do not alleviate the plights of citizens, or are not tailored to address their concerns.

The narrow pursuit of neo-liberal economic policies of the form prescribed by many international financial institutions, including a minimalist, market-oriented approach to development policy, has not borne fruit in many countries. Such prescriptions advocate a state that is active in pro-

the human development index. Nigeria has one of the highest levels of FDI flows in Africa, but was ranked 158th in the same report, demonstrating that FDI alone cannot make countries socially sustainable – even countries without the challenges of post-conflict recovery.

“Development in post-conflict countries cannot be left solely to market forces”

moting and protecting investment, but passive in regulating the activities of private investors. These policies might be successful in attracting FDI, but they have very limited automatic benefits for the local economy. It is questionable whether adopting this prevailing wisdom in its entirety is appropriate and sustainable in post-conflict countries.

Rwanda is seen by many as an FDI “success story”, because it has adopted policies considered by international financial institutions to be ideal, implementing a largely deregulated investment regime in order to attract FDI. But despite this perceived success in attracting FDI, the UNDP Human Development Report 2007/2008 ranks Rwanda 161 out of 177 countries on

The task of poor developing countries, and particularly those emerging from years of conflict, cannot be left solely to market forces. Post-conflict countries should be aiming to build a state with functioning institutions that drive confidence in the investment sector without administrative bottlenecks, but which does not trade the wellbeing of the population in the competition for foreign capital. It is clear that further research is needed to explain the dynamics of FDI in post-conflict countries, and in particular to develop mechanisms for assessing its positive and negative impacts. Policy decisions aimed at promoting FDI should be informed by detailed analysis of their potential side-effects on local people and the local economy.



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