

Helpdesk Research Report

The shadow economy in conflict-affected countries

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Question

What approaches can be used to (i) Leverage the positive social function that shadow economies provide to conflict-affected populations and (ii) Incentivise war profiteers to join the legal economy in post conflict environments?

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1. Overview

Targeting the shadow economy in conflict-affected contexts is a complex task about which **little is known** (expert comment). This rapid literature review uncovered little focusing on interventions aimed at incentivising war profiteers to join the legal economy and even less on leveraging the positive social function that shadow economies can provide to conflict-affected populations.

The majority of the literature uncovered during this rapid review were academic articles, written by a relatively small pool of writers. There has been much less focus on addressing these questions in more recent literature, although the gaps in knowledge still exist.

Criticism has been made in relation to the **lack of strong evidence** provided in the literature in relation to interventions tackling war economies (Evans, 2011, p.28) and “little practical guidance exists” (Ballentine and Nitzschke, 2005, p.14). There are mentions of the need for incentives to persuade shadow entrepreneurs to join the legal economy. However, there are few details about how this has been or can be done (e.g. Ballentine and Nitzschke, 2005, p.28, Guistozzi, 2007, p.86; Malone and Nitzschke, 2005, p.14).

Nevertheless, despite being “a **very complex issue** to which there is **no quick solution**” (expert comment), a number of lessons and suggestions have emerged of approaches which can be used to (i) leverage the positive social function that shadow economies provide to conflict-affected populations; and (ii) incentivise war profiteers to join the legal economy in post conflict environments. These include flagging up interventions which have had a detrimental impact.

Approaches which can be used to **leverage the positive social function** that shadow economies provide to conflict-affected populations include:

- Using **humanitarian aid** to complement people’s coping strategies (Goodhand, 2006).
- Understanding the relationship between different aspects of the economy through **stakeholder assessments** can reduce the risk that interventions have detrimental impacts on people’s coping strategies (Ballentine and Nitzsche, 2005).
- Strengthening **state capacity to provide basic services, security, and employment** to its citizens so they do not have to rely on predatory elements of the shadow economy (Ballentine and Nitzschke, 2005).
- Providing **alternative livelihood opportunities** (Looney, 2006).

Approaches which have been **detrimental to leveraging the positive social function** that shadow economies provide to conflict-affected populations include:

- Interventions which have **not considered the context** often result in negative consequences for conflict-affected populations (Pugh and Cooper, 2004).
- **Privatisation policies** have resulted in the loss of social protection (Goodhand, 2004).

Approaches which can be used to **incentivise war profiteers to join the legal economy** in post conflict environments include:

- Raising the cost of involvement in the shadow economy through:
 - **Sanctions and control regimes** (Ballentine and Nitzschke, 2005). **Strengthening regulations** (Looney, 2006). **Improving resource governance** (Nitzschke and Studdard, 2005).
- Creating the right conditions for investment through **strengthening the state’s capacity to provide a secure and predictable environment** (Goodhand, 2004).
- Providing **positive inducements and support** to encourage profiteers to invest in legitimate business (Goodhand, 2004).
- Providing **alternative livelihood options** (Malone and Nitzschke, 2005). Including through Demobilisation, Disarmament, and Reintegration (DDR) programs (Ballentine and Nitzschke, 2005).
- Encouraging profiteers **own incentives** to join the legal economy (Guistozzi, 2007).
- Taking a **regional approach** to ensure that the shadow economy does not shift elsewhere (TDRP, 2012).

Approaches which have been **detrimental to incentivising war profiteers** to join the legal economy in post conflict environments include:

- **Lack of support for a strong effective state** means profiteers have no incentive to join the legal economy (Goodhand, 2004).

- **Criminalising the profiteers** without also providing incentives results in negative consequences (Goodhand, 2004).

2. The shadow economy in conflict affected contexts

In order to either leverage the positive social function that shadow economies can provide to conflict-affected countries, or to incentivise war profiteers to join the legal economy in post-conflict environment it is important to have a good understanding of the different functions of war economies. Goodhand proposes a particularly useful distinction between “combat”, “shadow”, and “coping” economies (Goodhand, 2004 in Ballentine and Nitzschke, 2005, p.7 – see Table 1). The combat economy refers to the economic activity which sustains the armed conflict. The shadow economy includes the broad range of activities aimed at making a profit on the margins of conflict and outside of state-regulated frameworks. The coping economy describes economic activities which enable the civilian population, particularly the poor and most vulnerable, to survive (Ballentine and Nitzschke, 2005, p.7-9).

It is important to understand the different actors, motivations, economic activities, and the relationships between the different economies as they can have different implications for conflict resolution and post-conflict peacebuilding interventions (Ballentine and Nitzschke, 2005, p.7; Goodhand, 2004, p.82). This helps in understanding the incentives and disincentives for actors to move to the legal economy.

Table 1: Economies, actors, motives, and activities during armed conflict

	The Combat Economy	The Shadow Economy	The Coping Economy
Who? <i>Key actors</i>	Security apparatus of the state, rebel fighters, “conflict entrepreneurs”, suppliers of weapons and military equipment	Profiteers, transport sector, businessmen, drug traffickers, “downstream” actors (e.g. truck drivers, poppy farmers)	Poor families and communities
Why? <i>Motivations and incentives for war and peace</i>	To fund the war efforts or achieve military objectives. Peace may not be in their interest as it may lead to decreased power, status, and wealth. Fighters may have an interest in peace if there are alternative livelihoods available.	To make a profit on the margins of a conflict. Peace could be in their interest if it encourages long-term investment and licit entrepreneurial activity. Peace requires alternatives to the shadow economy; otherwise a criminalised war economy will become a criminalised peace economy.	To cope and maintain asset bases through low-risk activities, or to survive through asset erosion. Peace could enable families to move beyond subsistence.
How? <i>Key activities and commodities</i>	Taxation of licit and illicit economics activities; money, arms, equipment, and mercenaries from external state and non-state supporters; economic blockages of	Smuggling of high-value commodities; mass extraction of natural resources; Hawalla (currency order and exchange system); aid manipulation.	Employment of diverse livelihood strategies to spread risk; lootable resources; cross-border smuggling; subsistence agriculture; petty trade; on-farm and off-farm wage

	dissenting areas; asset stripping and looting; aid manipulation.		labour; labour migration and remittances; humanitarian and rehabilitation assistance.
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Source: Adapted from Ballentine and Nitzschke, 2005, p.8

In his book chapter looking at the war economy in Afghanistan, Goodhand (2004) points out that the networks between these economies overlap and reinforce one another (p.81). He uses the example of the opium trade in Afghanistan to illustrate this. “For a resource-poor farmer, poppy cultivation is part of the coping or survival economy; for the landowner leasing land, or for the opium trader, it is part of the [shadow] economy; and for the commanders that tax cultivation it is part of the [combat] economy” (Bhatia and Goodhand, 2003, p.74). Therefore interventions which target one aspect of this network will impact on the others. This can have adverse effects on the survival strategies of conflict-affected populations as the shadow economy sustains livelihoods and “compensate[s] for the state’s incapacity or neglect in providing basic services” (Nitzschke and Studdard, 2005, p.230).

In their article on the legacies of war economies, Nitzschke and Studdard (2005) point out that interventions in conflict-affected contexts have to address the negative impacts of the shadow economy without losing its socially beneficial aspects (p.230). This is complicated by the fact that the shadow economy’s positive and negative functions exist on overlapping networks (Nitzschke and Studdard, 2005, p.230). Looney (2006) in his study of the shadow (or informal) economy in Iraq points out that what may work in encouraging broad-based groups to join the legal economy may impact detrimentally on the more vulnerable (Looney, 2006, p.13). The complexity of the situation means that there is a need for long-term programming (Goodhand, 2004, p.68).

3. Positive social functions for conflict-affected populations

In their discussion paper, Malone and Nitzschke (2005) describe how “artisanal diamond mining activities in Sierra Leone, coca and poppy cultivation in Colombia and Afghanistan, as well as diaspora remittances in Sri Lanka, Kosovo, and Nepal have become critical sources of survival for the civilian population” (p.6). Despite often being under the control of armed groups, the incomes civilians can make from these activities enables their survival as it “sustain[s] livelihoods and compensate[s] for the state’s failure to provide basic services” (Malone and Nitzschke, 2005, p.6).

Vulnerable groups

However, Lonney’s (2006) study in Iraq illustrated that the most vulnerable groups, such as women and children, are often trapped in the shadow economy (p.14). In Afghanistan, the shadow economy has led to widening socio-economic differences in the population; Goodhand argues to the detriment of the poorest (2004, p.64). In their article on the legacies of war economies, Newman and Keller (2007) point out that the coping economy cannot be used as a substitute for public service delivery, especially because it empowers “paramilitary criminals who have the potential to undermine the rule of law” (p.57). Therefore strategies to combat the negative impacts of the shadow economy in conflict affected contexts need to balance acknowledgement of its positive social functions with acknowledgement of its more detrimental impacts and the fact that it cannot be a long-term solution to providing social support.

Below are a number of approaches aimed at leveraging the positive social function of the shadow economy to conflict-affected populations, with evidence and suggestions of what might work and what doesn’t work.

3.1 Beneficial interventions

Using humanitarian aid to complement coping strategies

Goodhand (2006) points out that in Afghanistan, humanitarian aid has played a significant role in people's coping strategies as the "second largest sector in the illicit economy after agriculture" (p.70). As a result of the supportive role humanitarian aid can play alongside the positive social benefits of the shadow economy, Ballentine and Nitzschke (2005) recommend that humanitarian and development aid is designed to ensure benefits for those civilians who are also dependent on the illicit aspects of war economies (p.18). Donor agencies need to ensure that their post-conflict economic interventions adequately account for these positive social functions of shadow economies (Ballentine and Nitzschke, 2005, p.19).

Understanding the context through stakeholder assessments

In order to ensure that interventions leverage the positive social functions that shadow economies provide to conflict-affected populations, Ballentine and Nitzschke (2005) recommend that stakeholder assessments focusing on people's coping strategies and its vulnerabilities should be required before any external intervention takes place (p.10). Goodhand (2004) echoes this point with his emphasis on the importance of "fine-grained analysis" in order to fully understand the context and the relationships between the different aspects of the economy and its impact of different people (p.72). Böge and Spelten (2005) also point out the need for an awareness of gender differences in relation to the shadow economy and approaches to it (p.68).

A detailed understanding of the context is important because of the problems with standardised, 'off the shelf' interventions (Véron in Evans, 2011 p.28). This is because "measures that may work in one given post-conflict area could prove disastrous in another" (expert comment).

Strengthen state capacity to support its citizens

Ballentine and Nitzschke (2005) argue that the approach that is needed to leverage the positive social functions of the shadow economy is for "the state's capacities to provide basic services, security, and employment ... to be strengthened in order to free civilians and conflict dependents from the often predatory control of war-lords and mafia structures" (Ballentine and Nitzschke, 2005, p.19). These predatory actors can reduce the positive social functions the shadow economy might have. Collinson, in her report on livelihoods and conflicts agrees with Ballentine and Nitzschke, suggesting that improving the governance structure around resource exploitation is better for local livelihoods than sanctions (Collinson, 2003, p.15).

Provide alternative livelihood opportunities

Goodhand (2004) suggests that interventions need to provide alternative livelihood opportunities through the provision of jobs or equivalent compensation (p.59; see also Ballentine and Nitzschke, 2005, p.19). This point is echoed by Nitzschke and Studdard (2005) who also suggest that the provision of alternative livelihoods is important to the growth of the legal economy (p.234).

Looney (2006) also emphasises the need for alternative livelihood opportunities, arguing that child labour can be combatted through government provision of family subsidies that make children less important for supplementing family incomes (p.14). This needs to be accompanied by an enforced ban on child labour and improvement of education system as an alternative (Looney, 2006, p.14).

3.2 Detrimental interventions

Lack of informed interventions

The literature uncovered for this review also reveals a number of approaches that have been taken which either fail to leverage the positive social function of shadow economies or which have had a detrimental impact on them. Ballentine and Nitzschke (2005) point out that “failing to distinguish between stakeholder interests, livelihood strategies, and vulnerabilities may lead to external interventions that harm conflict dependents, destroy what little economic activity remains on a local level, while raising the profit margins for those who control violence and violent economies” (p.10). For example, the lack of consideration around the use of sanctions aimed at timber in Liberia lead to a detrimental impact on the livelihoods of civilians (Pugh and Cooper, 2004, p.228).

Privatisation policies

One approach which a number of authors agree has been detrimental to leveraging the positive social functions which shadow economies have for conflict-affected populations are privatisation policies. Goodhand (2004) points out that they have raised tensions and “provid[ed] opportunities for elite enrichment, while stripping away forms of social protection” (Goodhand, 2004, p.79). Nitzschke and Studdard’s (2005) research in several countries suggests that the focus of donor agencies on “early privatisation, economic liberalisation and macroeconomic stabilisation may well be counterproductive” (p.234). This is because these policies “risk hurting those who have come to depend on the shadow and coping economies in conflict and post-conflict settings, while benefiting corrupt elites” (Nitzschke and Studdard, 2005, p.234).

4. Returning to the legal economy post-conflict

The problem for approaches aimed at incentivising war profiteers to join the legal economy is that these people often have an interest in the continuation of conflict (Ballentine and Nitzschke, 2005, p.3). However, a distinction can be made between ‘conflict entrepreneurs’ and ‘economic entrepreneurs’ as the latter “may have an interest in peace, if peace enables them to maintain or increase their profits” (Bhatia and Goodhand, 2003, p.71). Therefore, Goodhand (2005) argues that understanding incentives of the war profiteers for their involvement in the shadow economy is crucial (p.82). The approaches need to address the issues with ‘carrots and sticks’ by raising the costs of involvement and creating attractive alternative opportunities (Ballentine and Nitzschke, 2005, p.19). The aim of these approaches is to find a way “to make peace more profitable than war” (Ballentine and Nitzschke, 2005, p.10). However Böge and Spelten (2005) warn that the approaches aimed at war profiteers are unlikely to be able to make up for their ‘losses’ in leaving the shadow economy (p.66).

The literature on approaches to incentivise war profiteers to join the legal economy contains evidence and suggestions of what might work and what doesn’t work. These will be explored in more detail below.

4.1 Beneficial interventions

Raising costs through sanctions and control regimes

Ballentine and Nitzschke (2005) recommend the use of “control regimes”¹ to raise the costs for war profiteers by reducing the profitability of resource flows in conflict contexts (pp.10-15). They outline **examples** such as targeted commodity sanctions imposed by the UN Security Council; the Kimberly

¹ Control regimes are international efforts aimed at curtailing resource flows to combatants (Ballentine and Nitzschke, 2005, p.3).

Process Diamond Certification Regime; efforts to establish financial transparency in the extractive industries; and interdiction regimes aimed at transnational organised crime, corruption, money laundering and drug trafficking (Ballentine and Nitzschke, 2005, pp.10-15). Böge and Spelten (2005) add that sanctions, for example, should also be kept in place in a modified form until the transition to a peaceful and legal economy has been secured in order to ensure that the costs of engaging in the shadow economy remain high (p.67).

However there are a number of **problems with this approach**. Sanctions increase the value of the resources which makes them more lucrative for profiteers (Ballentine, 2003, p.279). Control regimes also face enforcement problems (Ballentine and Nitzschke, 2005, p.13). In addition, sanctions and other forms of control regimes can have negative unintended consequences. Ballentine and Nitzschke (2005) warn that they may result in “increasing civilian predation by rebel groups seeking to supplement lost revenues and materials”, as well as putting strain on already pressured livelihoods by depriving civilians who rely on these illegal commodities of important income (p.14).

Strengthening regulations and rule of law

Another way in which the cost of involvement in the shadow economy can be raised is by strengthening **rule of law**. Looney (2006) points out that a stronger legal framework and enforcement system will raise the costs of operating in the shadow economy (p.13). Ballentine and Nitzschke (2005) also suggest **improving law enforcement and judicial bodies** (pp.18-19). Nitzschke and Studdard (2005) recommend that in some cases, policing will have to be carried out by external actors in the initial post-conflict phase to “ensure a degree of security and tackle the most egregious crimes” (Nitzschke and Studdard, 2005, p.234).

There are also calls for more **regulations** and support for a transfer of shadow economy activities to the legal economy. This is what occurred for example with taxi drivers in Kosovo (expert comment). Ballentine (2003) suggests that regulations aimed at the financial networks underpinning the “illicit conflict trade may be more effective than measures aimed at controlling their physical movement” (p.278).

Improving resource governance

The costs of involvement in the shadow economy could also increase through approaches aimed at improving resource governance (Ballentine and Nitzschke, 2005, pp.15-16). Nitzschke and Studdard (2005) suggest that assistance should be aimed at “**capacity building** for public administration, particularly in the areas of financial oversight, budgeting, accounting and public expenditure reviews” (p.235). International agencies can also act as **independent monitors** to ensure compliance with natural resource funds and the fair distribution of income generated by resources (p.235). Nitzschke and Studdard (2005) argue that “if properly administered, these could protect the large inflows of revenues from rent-seekers, and safeguard their productive use for peacebuilding and reconstruction” (p.235). International support is needed for initiatives such as the Extractive Industries Transparency Initiative and the Publish What You Pay Campaign, which “seek to promote fiscal transparency among corporations and host governments engaged in extractive industry operations” (Nitzschke and Studdard, 2005, p.235).

As well as improving resource governance to raise the cost of involvement in the shadow economy for war profiteers, peace processes could encourage a move to the formal economy by including provisions for resource-sharing which mean that various actors can have legitimate access to these resources (Ballentine and Nitzschke, 2005, p.18).

Creating the right environment for investment facilitated by a strong state

Positive incentives for war profiteers to join the legal economy post-conflict can come about through the creation of the right environment for legal investments and economic activity. This environment can be created by a strong state, as a strong state with a monopoly on the use of force provides a “secure and predictable environment for legitimate commerce” (Goodhand, 2004, p.82). This will help to encourage profiteers to invest their war-time profits in the legal economy (Goodhand, 2004, pp.48-29). If they are able to retain control of the smuggling and drugs trade, there is no incentive for war profiteers to engage with the state or legal economy (Goodhand, 2004, p.61).

Ballentine and Nitzschke (2005) also argue that war-torn states need to create better functioning and more accountable governments and markets (p.72). In addition, Goodhead (2004) points out the benefits of a strong state as it accelerates economic development and poverty reduction, consolidates peace, reduces the scope for extreme brutality and the predatory exploitation of social relations, and withstands the intrusive interests of regional powers (p.73). Without a strong state “profiteers tend to reap the lion’s share of benefits, while communities engaged in subsistence and survival become increasingly vulnerable as they are exposed to the turbulence of regional and international markets” (Goodhand, 2004, p.60). Therefore supporting the creation of a strong state is advantageous to ordinary citizens, as well as creating an encouraging environment for war profiteers to invest in. Woodhead (2004) warns that “[w]ithout a state that can provide a legal framework and stable environment, a criminalized war economy will simply become a criminalized peace economy” (p.76).

Following on from the above point about the detrimental impact of privatization policies, an expert commentator suggests that the best incentive for a move to the legal economy is the creation of a “social state” (expert comment). Building welfare institutions and not just institutions supporting a free market means that people need to rely less on the shadow economy and can rely more on “universal welfare” and jobs in the legal economy (ibid).

Positive inducements and support

The literature recommends positive inducements to encourage profiteers to invest in legitimate business. For example, with the right support and institutional framework the ‘hawalla system’ in Afghanistan could move to the formal sector (Goodhand, 2004, p.79). On the other hand, when it comes to some very particular markets, formalisation/integration to the legal economy, can sometimes take place simply by “marginalising the informal agents through competition (or buying them over to the formal side by giving them employment)”, as occurred for example with the pirate CD market in Serbia (expert comment).

Looney (2006) suggests that maintaining low taxes, as well as macroeconomic stability, would help provide incentives for a move into the formal sector (p.13, p.15). In addition, he suggests that this approach could be supported by an expanded social net designed to provide short term security, especially for two of the more vulnerable groups, women and children (Looney, 2006, p.15).

Providing alternative livelihood options

Another important incentive for the move of war profiteers to the legal economy is the creation of alternative income-generating activities for entrepreneurs and others engaged in the shadow economy (Malone and Nitzschke, 2005, p.14). For example, Goodhand (2004) makes clear that there needs to be the investment of significant development resources in poppy growing areas of Afghanistan for eradication policies to be effective as people need to be provided with alternative livelihood options (Goodhand, 2004, p.78, p.81). Véron (in Evans, 2011) adds that economic growth, and therefore pro-growth policies, are the best way to encourage people to move from the shadow economy (p.28-29).

Providing alternatives through Demobilisation, Disarmament, and Reintegration (DDR) programs

An important group of people who may have profited from war are ex-combatants and therefore it is important that DDR programs offer meaningful incentives for combatants (Ballentine and Nitzschke, 2005, p.15). These interventions need to take into account of different incentives for rank-and-file and mid-level commanders, who will need greater incentives as they often have more to lose (Ballentine and Nitzschke, 2005, p.19). Malone and Nitzschke point out that assistance needs to come early in order to remove the temptations for continued participation in the war economy (p.14). Ballentine and Nitzschke (2005) also highlight the importance of funding “quick impact” projects aimed at job provision and alternative income-generating activities (p.19). Nitzschke and Studdard (2005) argue that by ensuring expanded and meaningful economic opportunities through the provision of education and employment DDR programs could combat the temptation to remain involved in the war economy (pp.228- 229). However the interventions need to be appropriate for local economic context. For example, farming should not be encouraged as an alternative livelihood if the local agriculture sector cannot absorb more farmers, as was the case in parts of Afghanistan (Nitzschke and Studdard, 2005, p.229).

Encouraging profiteers’ own incentives

War profiteers may also have their own incentives for joining the legal economy which could be encouraged. Guistozzi’s (2007) study in Afghanistan suggested that the strongmen and warlords in Afghanistan viewed investment in the legal economy as a way to consolidate their influence because of the patronage they could wield through it by providing jobs and other benefits (p.79). He argues that as long as peace posed no threat to their positions and networks of power, warlords had no reason to object to it (Guistozzi, 2007, p.79). This incentive structure however, creates the danger of war profiteers simply turning into a mafia (Guistozzi, 2007, p.81).

Taking a regional approach

An important point emerging from the literature is that any approach to incentivise war profiteers to join the legal economy needs to take a regional approach. Otherwise “disciplinary regulation” may just shift the shadow economy to neighbouring territories (TDRP, 2012, p.4). Malone and Nitzschke (2005) suggest that to “tackle the regional shadow trade and smuggling in countries with weak border policing capacities, structural incentives for licit cross-border trade need to be created” (p.14). This can be supported through “improved cooperation within regional and sub-regional organizations (such as ECOWAS or the Mano River Union) or through multilateral agreements” (Malone and Nitzschke, 2005, p.14).

In addition, when creating incentives by making countries more attractive investment projects, the regional context should be considered. For example, Goodhand (2004) points out Afghanistan’s potential as a regional hub (p.79).

4.2 Detrimental interventions

Lack of support for a strong effective state

Experience from Afghanistan has shown that war profiteers are not encouraged to join the legal economy if there are no interventions aimed at combatting the shadow economy. Goodhand (2004) suggests that “international neglect has been a significant factor in the development and expansion of Afghanistan’s shadow economy” (p.73). The lack of encouragement and support for a strong state and a legal framework to protect property rights and enforce contracts, means there are few incentives for entrepreneurs to make the shift toward longer-term productive activities (Goodhand, 2004, pp.64-65).

Criminalising the profiteers

An approach which has not worked is one which focuses on just criminalising the profiteers to raise the costs without also offering positive incentives (Goodhand, 2004, p.48, p.71). This can have negative repercussions as, for example, Goodhand (2004) points out “a complete closure of the border between Afghanistan and Pakistan and the cessation of illegal trade would likely create the conditions for a social explosion in several regions of Pakistan, as cross border trade is central to the coping and survival strategies of border communities” (p.71).

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