

# Changes in economic activity during and after conflict

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22.03.2017

## Question

What evidence exists on how economic activity that changes during conflict is entrenched post conflict?

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## 1. Overview

Conflict changes economic activity in a number of ways. This report looks at whether these changes in economic activity become entrenched after conflict has ended. The available evidence found within the scope of this report suggests that the extent to which changes in economic activity become entrenched after conflict depends on how developed a country was prior to conflict breaking out. Thus, the more developed a country was pre-conflict, the more quickly it is likely to recover economically after conflict.

Specific economic challenges faced by countries during and after conflict include:

**Labour market issues:** Conflict often causes an increase in unemployment and a rise in informal activities. These changes generally persist post conflict, due to a lack of opportunities, and due to job seekers having inappropriate skills for the jobs that are available.

**Illicit economic activities:** Conflict tends to result in an increase in illicit economic activities. These illicit economic activities tend to continue post conflict, as those who have been profiting from them are reluctant to abandon lucrative sources of income.

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**Private sector decline:** This often continues post conflict, due to skills shortages and problems with infrastructure, which make normal operations difficult.

**Capital flight:** The flow of assets out of a country can reduce, continue, or be reversed post conflict.

**Small tax base:** The rise in the informal sector during conflict, means that states emerging from conflict are left with a very small tax base. This, in turn, makes it difficult for the state to meet citizens' basic needs and impedes the establishment of a stable system of governance.

**Inflation:** The presence of international organisations and bilateral donors can generate inflation in post-conflict settings.

**Trade:** During internal conflict, imports tend to reduce. However, after conflict trade often increases, with countries frequently experiencing a rise in exports.

There is a relatively small body of English language literature on whether changes in economic activity during conflict become entrenched post conflict. The available literature consists of reports by international organisations, academic journal articles, and working papers. In terms of methodology used in the literature, there is a relatively even number of quantitative and qualitative studies. The literature considered in this review was largely gender-blind.

## 2. Changes in economic activity during conflict

According to UNDP, there are three types of war economy:

- In **combat economies** 'combat networks' fill the gaps created by 'destroyed social bonds and community-level exchanges' (UNDP, 2008, pp. 38-39). Moreover, rent-generating wartime activities become one of the central features of conflict (UNDP, 2008, pp. 38-39). Elites tend to be the key players in such economies, but criminal profiteers and speculators are reportedly also involved (UNDP, 2008, pp. 38-39). In combat economies, the aforementioned elites tend to resort to corruption and criminality, including the illegal exploitation of natural resources. They are also sometimes engaged in the capture of diaspora remittances and aid flows. Armed groups use these revenues to fund and sustain conflict (2008, pp. 38-39)
- **Shadow economies** are characterised by economic activities that take place outside state-regulated frameworks (UNDP, 2008, p. 39). They include, but go beyond, combat economies. The main actors in shadow economies are entrepreneurial elites who seek to profit from the mix of corruption, weak governance and porous borders created by conflict. They sometimes engage across enemy lines to make 'lucrative commercial deals' (UNDP, 2008, p. 39).
- **Coping economies** encompass informal activities adopted as a means of coping and survival when government-provided services and employment in the formal sector are not available (UNDP, 2008, p. 39). Examples include the production of pots, furniture and tools, and the production, cooking and sale of food (UNDP, 2008, p. 39).

## **Labour market issues**

Conflict can have a negative impact on employment due to disrupted markets, lower levels of public spending, and a reduction in key imports for productive activities (UNDP, 2008, p. 40). Internal conflicts generally affect the demand side of labour markets, as private and public investment collapse. This results in high and persistent unemployment (UNDP, 2008, p. 40). Cross-border conflicts on the other hand generally affect the supply side (UNDP, 2008, p. 40). Conflict often results in a significant increase in informal activities. This is because people who have lost formal employment seek to survive through informal production and exchange (UNDP, 2008, p. 40).

## **Illicit economic activities**

According to UNDP, illicit economic activities tend to increase during conflict, as it 'reduces the state's power to regulate and increases opportunities for drug production and trade, smuggling and theft' (2008, p. 37).

## **Private sector decline**

The primary effects of internal conflict on firms include disruption of production through 'the flight of employees, unreliability of transport, and fear of looting' (Collier & Duponchel, 2010, p. 3). Firms reduce the size of their inventories due to these factors. The costs of this disruption 'can be characterized as technical regress in the formal, private sector of the economy and so raise the unit cost of its output' (Collier & Duponchel, 2010, p. 3). Firms are also affected by a reduction in demand. This is due to a reduction in incomes, especially cash incomes, as people move their assets abroad for safety, and move into informal subsistence activities (Collier & Duponchel, 2010, p. 3).

## **Capital flight**

The effect of conflict on capital flight depends on the 'nature, intensity and duration of the conflict' (Davies, 2010, p. 3). In resource rich countries, primary commodities, such as diamonds, narcotics, or timber, can serve as vehicles for capital flight during conflict. Thus, in countries rich in natural resources that can be sold abroad relatively easily, the impact of violent conflict on capital flight can be much larger than in countries that lack natural resources (Davies, 2010, p. 3).

## **Trade**

Internal conflict tends to result in fewer imports, whereas cross-border conflict is not always associated with lower levels of imports (Marano et al, 2013, p. 218). This is because internal conflict is more likely to cause societal divisions and tensions, resulting in the destruction of both the physical and societal infrastructure that are vital for productive and trading activities (Marano et al, 2013, p. 218). Cross-border conflict on the other hand is less likely to seriously damage a country's physical infrastructure and 'societal fabric' (Marano et al, 2013, p. 218).

### 3. Economic activity post conflict

On average, post-conflict economies grow faster than normal as they quickly recover from the damage done during conflict (AfDB, 2009, p. 44). However, performance varies widely, with some post-conflict societies not undergoing rapid economic recovery. According to the African Development Bank, this variability suggests that performance during the post-conflict period is particularly sensitive to policy choices (2009, p. 44). A peer-reviewed academic journal article finds that rapid recovery occurs in the more-developed post-conflict societies, but that the consequences of conflict last far longer and are more severe in less- and least-developed societies (Kugler et al, p. 8). Moreover, Gates et al find that even where there is rapid economic growth post conflict, economic performance will vary across sectors (2012, p. 1720). They argue that the most likely reason for rapid economic recovery is international assistance (Gates et al, 2012, p. 1720). The presence of international organisations and bilateral donors in post conflict settings can also hinder economic recovery. Tying aid to donor goods and services rather than stimulating the local economy through local procurement, and a tendency to 'substitute for instead of relying upon and building local capacities' are examples of ways in which aid can impede economic recovery (Manning & Trzeciak-Duval, 2010, p. 110).

Combat and shadow economies complicate economic recovery after war in several ways:

- They can limit the opportunities for policy change after conflict. Those who profit from war are often also those who 'won' the conflict. Therefore, they can use the wealth and power they have accumulated during conflict to influence the terms of peace agreements, or to undermine agreements that they believe will not serve their interests (UNDP, 2008, p. 39).
- Ex-fighters often become part of transitional governments and are responsible for overseeing post conflict economic recovery. However, according to UNDP, 'transparent fiscal systems, economic justice or other reforms aimed at promoting general welfare and national economic recovery, are not always in their interests' (2008, p. 39).
- Post-conflict governing elites often have access to large volumes of 'ill-gotten profits,' which far exceed donor funding. This reduces donor leverage for reform (UNDP, 2008, p. 39).
- The continuation of combat and shadow economies can make it difficult for states to mobilise tax and customs revenues (see also section on taxation). Not only do they undermine revenue capabilities, they also reduce the financing available to the state to rebuild infrastructure and improve social service provision (UNDP, 2008, p. 39).

#### Labour market issues

Very high unemployment and under-employment tend to persist long after conflict has ended (UNDP, 2008, p. 40). Post conflict, there are often limited jobs and those that are available generally pay less than conflict-related work. Moreover, job seekers' skills are often poorly suited to post-conflict rebuilding needs (UNDP, 2008, p. 40). Youth unemployment is often a particular problem, as post-conflict countries tend to have a large proportion of young people. Young men who return from war and cannot find employment may end up participating in illicit economic activities or take up arms again, either in their home country or in a neighbouring country (UNDP, 2008, p. 40). Even those who manage to find employment can suffer reduced purchasing power

due to the high inflation rates that are sometimes experienced by conflict economies (UNDP, 2008, p. 40). International organisations and bilateral donors can exacerbate the situation by depriving the local economy of qualified professionals who choose to work as well paid drivers of donor agencies over working as poorly paid government officials (Manning & Trzeciak-Duval, 2010, p. 110).

Subsistence farming and forestry and fishery enterprises are often severely affected by conflict. This is due to the disruption or destruction of transport and communications networks, and due to farm workers fleeing for safety, or to join government or insurgent military units. Women stopping tending their fields for fear of attacks by soldiers, also has a negative impact on farming (UNDP, 2008, p. 40).

According to a UNDP report, the informal sector in the post-conflict economy tends to be larger than in developing countries not affected by conflict. Moreover, it tends to work differently and benefit different people (2008, p. 38). A large informal economy results in a smaller tax base (see section on taxation) (International Peace Academy, 2003, p. 10).

One peer reviewed journal article discusses the impact of demographics on labour market issues in post conflict settings. The article argues that post conflict baby booms increase the productivity of more-developed societies, as they have been able to preserve the human capital that was acquired by previous generations (Kugler et al, pp. 8-9). It goes on to argue that as a result, these countries' young populations can out-produce, with newer equipment, their 'less-devastated, most-developed competitors' (Kugler et al, pp. 8-9). However, in the least-developed societies, baby booms increase the number of low skilled young people. In these cases, population recovery means that the economic losses incurred during conflict are preserved. These countries lose recently acquired human capital, and are unable to educate their youth, even to pre-war levels (Kugler et al, pp. 8-9). The authors suggest that in such cases foreign aid may be the determining factor between rapid economic recovery and stagnation (Kugler et al, pp. 8-9).

### **Illicit economic activities**

According to Brown 'the availability of easy money in the form of illicit commodity trade and exports has systemic effects for those countries coming out of conflict' (2006, p. 9). Those who have benefited economically from conflict, including from sanctions regimes, aim to consolidate their power once conflict has ended (International Peace Academy, 2003, p. 10). They do this by increasing their control over the local economy and political processes. 'Economic criminality is difficult to root out, not only because criminal networks are highly adaptive, but also because of the vital economic and social functions that they have often come to serve' (International Peace Academy 2003, p. 10).

### **Private sector decline**

The decline in the private sector experienced in many post conflict settings is closely linked to the labour market issues discussed above. Conflict induced technical regress causes a reduction in output in response to a decline in demand, which in turn leads to a contraction of the labour force. The decline in employment then results in a loss of skills for the part of the labour force that loses employment (Collier & Duponchel, 2010, p. 4). Technical regress is reportedly characterised by a return to production practices that would be deemed inefficient in times of

peace. Collier & Duponchel provide the example of an absence of electricity forcing workers to switch to manual operations (2010, p. 25). They argue that 'in effect, [employees] learn reversionary techniques which peace will make redundant, and forget techniques which peace will again make feasible and superior' (2010, p. 25). This issue is reportedly only a problem in post-conflict settings, because firms that have adjusted to the conditions of conflict, find themselves unable to cope post conflict. This is due to the fact that while demand increases and they would be in a position to abandon the reversionary technologies, there is now a lack of skilled labour. Firms in conflict-affected areas must therefore manage with lower quality workers and are therefore less productive (Collier & Duponchel, 2010, p. 4).

### **Construction sector**

A diminished construction sector, due to fewer construction companies and a lack of skilled workers, slows post conflict economic recovery. It also results in booms in construction prices due to increased demand and limited supply. These price booms result in increased spending due to higher costs, and generate large 'rents' for those who control supply. This in turn creates space for political corruption (AfDB, 2009, p. 45).

### **Trade**

A quantitative study published by the IMF finds that trade is the most influential determinant of economic growth in post conflict settings (David et al, 2011, p. 23). Post-conflict situations are often linked to commodity export booms. This is the result of 'quantity effects, as production increases due to the resumption of normal operations and increases in investment, and positive price effects' (David et al, 2011, p. 23). Possible reasons for this include the fact that governments are in a better position to renegotiate the terms of extraction; possibly because more firms are willing to compete for extraction rights as political uncertainty reduces, leading to increased competition for such rights (David et al, 2011, p. 23).

### **Capital flight**

Capital flight that occurs during conflict may reduce, continue, or be reversed post- war (Davies, 2010, p. 4). The end of conflict can lead to a reduction in capital flight by decreasing political risks and by providing high-return investment opportunities in the domestic economy (Davies, 2010, p. 4). However, fears of a return to conflict could keep perceived risks high. Perceived risks are likely to reduce the longer peace endures (Davies, 2010, p. 4). According to the AfDB, whether or not capital flight continues is critical to economic recovery because the stock of assets held overseas is often very large relative to the economy (2009, p. 45). Reasons for continued capital flight may be:

- The process of moving assets abroad during the conflict had not been completed (AfDB, 2009, p. 45).
- New wealth, resulting from high profits post conflict, is being moved abroad due to concerns about further insecurity or conflict (AfDB, 2009, p. 45).

However, the above is not always the case. Uganda reportedly succeeded in attracting 'substantial human and financial capital repatriation' during the first ten years after conflict ended (AfDB, 2009, p. 45).

## Small tax base

Taxation may be particularly expensive in post-conflict settings because during prolonged conflict most economic activity takes place within the informal sector, resulting in a smaller tax base (AfDB, 2009, p. 47). This undermines the ability of states emerging from conflict to fund the provision of basic goods and services, most importantly security, to undertake needed reconstruction projects, and to establish viable institutions of governance (AfDB, 2009, p. 47). While post conflict foreign aid can help to bridge this gap, this is not a sustainable way of financing the state. The state's failure to provide basic services, and their provision by criminal or shadow networks, reportedly undermines the establishment of the 'social contract' required for 'stable and accountable governance' (International Peace Academy, 2003, p. 10).

## Inflation

Conflict often results in a high rate of inflation (AfDB, 2009, p. 47). The presence of international organisations and bilateral donors in post conflict settings can be one of the causes of this (Manning & Trzeciak-Duval, 2010, p. 110).

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## Suggested citation

Strachan, A.L. (2017). *Changes in economic activity during and after conflict*. K4D Helpdesk Report. Brighton, UK: Institute of Development Studies.

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