



Briefing Note 3: The Private Sector in Conflict-affected States

Context: Enabling environment is needed for boosting private sector in conflict affected states

The private sector has the potential to accelerate progress towards resilience and development in fragile or conflict-affected countries (FCAS), through investment that generates sustainable employment and improves infrastructure. FCAS benefit from private investment which provides infrastructure (physical and soft) and other services. Investment from abroad can help transfer modern technology, knowledge and management expertise. The local private sector can also contribute to inclusive development and growth, and can particularly enhance employment and skills development. Its partnerships with foreign firms and its relations with the government and international partners can shape the contribution of the local private sector to achieving the SDGs.

The role of private sector in the social and economic resilience and development is well evidenced. However, investors are faced with peculiar challenges in fragile and conflict affected countries. More systematic international support is needed for private sector development that is well adapted to conditions in fragile states, rather than driven by standard models, and which is designed to have impact on a large scale.

Despite the challenges private investors face at the end of a conflict, the evidence is that domestic and foreign private investment has taken place in fragile settings. While much of this investment has been in enclave projects in the extractive industries and sectors like mobile phones, fragile states have been able to attract significant foreign direct investment, e.g. in 2012 as much as \$2.9bn in DRC and \$1.3bn in Liberia. Such investment has the potential to generate public resources to finance social and economic goals in these countries, and link their economies to global supply chains. The challenge is to broaden the scope of private investment to provide infrastructure and other services and to generate employment, particularly for the increasing numbers of young women and men who are seeking jobs.

Key issues: overcoming obstacles to developing and engaging the private sector

Private sector development in countries affected by past conflict is particularly difficult as many of the enablers of private investment may not be in place. War destroys institutions, formal markets, property rights and infrastructure, and practices that allowed private firms to survive may be inappropriate for a peacetime economy. In particular, FCAS often have vast infrastructure needs which significantly impede private sector investment. The private sector may be trapped in a low level equilibrium and be unfamiliar with efficient markets. Private sector development in fragile situations is as much a problem of political economy as resolving technical issues of strengthening the enabling environment (peace, infrastructure, institutions, etc.), factor markets, services and management, etc. Reforms to improve the business environment are as difficult as any other reforms in a fragile political environment; if the classic business climate reforms had been in place, the country most likely would not be facing fragility.

Governments with limited capacity are challenged to manage foreign direct investment, particularly when it involves large projects in the extractive industries or complex sectors like infrastructure. Without impartial international support, such as access to high quality advice, there is a risk of entering deals unfavourable to the country that are vulnerable to later renegotiation and reputational damage, or excessive caution that delays decision making. Governments also have issues in managing contracts that are already in place, particularly in assuring that taxes and revenues due are fully paid, and that

companies adhere to standards involving environmental protection and employment and human rights. These are areas where international cooperation is indispensable, e.g. between tax authorities in investors' host countries and FCAS, and in the promotion of international norms such as the Extractive Industries Transparency Initiative, and the Equator Principles adopted by financial institutions, for determining, assessing and managing environmental and social risk in private sector projects.

Since deficient infrastructure is one of the greatest impediments to private investment in fragile states, private participation in infrastructure can have both direct and indirect impacts on the development of the private sector. Given the nature of infrastructure investment – large initial investments in immovable assets – investors are deterred by the risks of expropriation once the facilities are in operation, despite the lack of evidence that private investment in fragile states is more risky than elsewhere. Despite these perceptions of risk, according to World Bank data private investment in infrastructure in fragile states has still been significant. Private participation brings not only additional capital, but if well managed can also lead to shorter construction times, and provide operational economies, skilled managers and improved service. In countries where the risks for investment are high, the private sector can bring managerial skills through leasing and similar arrangements that can speed up project implementation, lower costs and improve service (e.g. Liberia power sector). Private participation in infrastructure in fragile states has generally not met the expectations of governments. Accelerating private investment in infrastructure in fragile settings will require blending of private and public sector finance, including much greater use of multilateral and bilateral finance and risk mitigation instruments (e.g. partial risk guarantees) to unbundle risk and provide assurance to investors (e.g. the Fula Rapids hydro project in South Sudan that was under preparation before the current hostilities).

Increasing exports from fragile states beyond natural resource based commodities and reducing imports could lead to sustainable growth, employment and poverty reduction, as well as a reduction in aid dependency. Most fragile states are currently unable to realize their export potential, even after allowing for their lack of skilled workers and uneven business environments. For example, exporting processed food would create a chain of positive linkages back to poor farmers and increase employment and incomes along the chain. Realizing this potential requires targeted support to strengthen the resident private sector and remove the binding constraints to exporting products where the country has an advantage, such as infrastructure and red tape. Increasing exports from fragile states also requires actions by the importing countries, such as opening their markets, reducing non-tariff barriers, and providing direct assistance to exporters in fragile states having to comply with importers' requirements, such as phytosanitary regulations. Importing countries can also work with their importing firms to facilitate linking fragile states to global supply chains.

Other challenges where G7+ governments will need assistance from partners include lack of pre-investment studies that broadly define the project, insufficient revenue streams that require investors to rely on government budget transfers, and limited capacity of governments to manage complicated processes for selecting investors

Key solutions: a call for action for accelerating private investment in fragile states:

A private sector that contributes broadly to inclusive economic growth, deepening skills and technology, job creation and infrastructure, will be critical if FCAS are to achieve the Sustainable Development Goals. The domestic private sector needs nurturing but is incapable alone of providing the level of investment needed to reach our goals. Greater levels of Foreign Direct Investment are needed, especially in infrastructure, and local and international effort is needed to facilitate this and to neutralize the risks of doing harm in fragile settings, especially but not exclusively in the natural resources sector. Private sector development and private investment in fragile settings requires public sector support and guarantees that go beyond the usual focus on reforms to the regulatory environment and PPPs. To overcome these obstacles:

- a) *Multilateral and international financial institutions should jointly review the extent to which they*

collectively catalyse private sector investment and mitigate non-commercial risks, including a review of the extent to which their current set of instruments (e.g. investment insurance, support for PPPs) appropriate in post-conflict poor country contexts, with a view to recommending reforms and identifying possible new instruments.

- b) For fragile states more emphasis should be placed on developing the capacity and size of the domestic private sector to be able to compete both locally and internationally and ensuring that it can compete for contracts under international public finance.*
- c) Physical infrastructure (roads, energy and water) and soft infrastructure (technology, skills and higher education) are the necessary enablers of private sector development, and help generate a vibrant economy. Thus development finance (concessional loans, guarantees and grants) should be raised and allocated to infrastructure projects, which often require heavy investment, and with private finance to lever incremental private investment.*
- d) International partners and g7+ governments should jointly review and remove obstacles for increasing exports from fragile states and for linking resident firms in fragile states to global supply chains.*
- e) Global standards for business practice in conflict-affected and fragile settings should be established and endorsed. These standards should build upon existing agreements such as the EITI and Equator Principles and could include issues like conflict and fragility assessments, transparency and governance standards, community dispute resolution mechanisms, transfer of capacity, and taxation commitments.*