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## **From Rent-seeking to Profit-creation: Private Sector Development and Economic Turnaround in Fragile States**

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# From Rent-seeking to Profit-creation

## Private Sector Development and Economic Turnaround in Fragile States

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**ABSTRACT:** The paper suggests a framework for evaluating the relevance of strategies of private sector development in fostering sustained economic turnaround in fragile and post-conflict situations. It highlights how fragility, violence and conflict change economic structures, introducing distortions, trapping agents into “short-termism” and changing incentives toward rent-seeking, and explores strategies for supporting shifting economic systems from predation to production.

*JEL:* D72, D74, O17, O40

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## 1. Introduction

### *i. Fragility, Economic Development and Turnaround*

Fragile states are characterized by marked propensity to relapse into crisis due to limited resiliency and persistent vulnerability to internal and external shocks. As many as 40% of fragile states fall back into crisis within 10 years (Walter 2004). Among the key causes of persistent vulnerability and risk of violence is failure to enter economic development is a key root cause of conflict (Collier *et al.*, 2003). Blomberg and Hess (2002) find that the links between internal and external violence and prosperity are strong and mutually reinforcing, with recession increasing the probability of conflict. Economic Development has been shown to play a critical role in reducing the risk of relapsing into conflict and violence (Elbadawi and Sambanis 2002, Elbadawi 2003).

Evidence suggests that supporting growth in low income countries is the best strategy to reduce conflict risk, diversify the economy and finally promote long term stability, and ultimately peace and prosperity in Africa (Collier 2009a). Collier (2009b) calls for economic development as the “true exit strategy” for international peacekeeping.

Accordingly, donors and multilateral development institutions have developed a multi-pronged approach to development in low income countries focused on program of reforms which are simultaneously aimed at stabilizing the macro-framework, building capacity and governance quality (mainly through strengthening of Public Finance Management parameters), supporting private sector development through regulatory reforms, and improve income-generating activities for the state (facilitating exploitation of natural resources often present, and export of wood and crops).

The return of sustained and permanent growth in fragile states and post-conflict affected situations has however proven to be particularly difficult and lengthy process. As micro and macro-insecurity persist at high levels after peace agreements are signed (Collier and Gunning 1995) reconciliation does not generate an immediate boost to the economy, While peace generates a quick windfall, immediate peace-dividends are small and recovery of private sector confidence is the key for accessing a (delayed) peace-

dividend (Collier 2005). On the other hand, initiating a turnaround is a lengthy process: Chauvet and Collier (2008) calculate that the mathematical expectation of fragile states entering turnaround phases is over 54 years. Fragile states faces a growth conundrum that can place them in a fragility trap.

Hence the importance of pursuing economy recovery strategies “with vigor” (Collier 2006) and present early good economic choices to ensure that conflict risk diminishes permanently after the first decade after peace.

It is against this backdrop that private sector developments strategies in fragile states have received renewed interest from international agencies and donors. Private sector development programs are now being proposed early on and integrated into peace-building and state-building activities<sup>†</sup>

Early lessons on the ground have led to important principles being integrated in the design of private sector development activities. On the one hand international agencies (UN 2009) are stressing the importance of initiating planning for transition to long-term sustained private sector development in the early phases of support from the international community, along with stabilization and local reintegration strategies. On the other hand, there is widespread agreement that private sector development should be approached with conflict sensitive programs designed around countries context.

## *ii. Different Approaches to Private Sector Development*

Programs come in the form of targeted support to individual economic agents, systemic support to sectors or markets, reform of the business climate, strengthening of economic structure (DCED 2008). Support to private sector development in fragile states cover a very broad range of different activities, including support to development of ‘non profit’ private sector (as a complementary vehicle to deliver services when public capabilities are particularly weak, or not available to part of the population), through

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<sup>†</sup> OED 1998 review of World Bank’s support to Post-conflict countries stressed that the Bank’s approach to assisting basic production sectors, including industry, “has been for the most part indirect, and concentrating on policy and institutional enabling environments and on infrastructure”. The performance of operations in support to microenterprise has been mixed.

market integrated interventions, private and public partnerships, and cooperation with multinational corporations keen on building on political stabilization to invest in exploiting natural resources and export-staples.

Donors' frameworks can be broadly categorized into two major approaches (DCED 2008).

Following the "investment climate approach" states are encouraged to develop a program of reforms (at macro-, fiscal and regulatory levels) to improve overall business climate parameters with the goal of laying the foundations for broad-based economic growth, encouraging both foreign and local investments. Investment climate reforms include promoting regulatory reform, reducing red-tape, strengthening of competition policy, improvement of property rights and their enforcement. Reforms also include measures to increase formality, as informality is seen as allowing predation-driven over production-driven sectors, and.

These comprehensive reforms to improve the quality of the state and the business environment face different sets of challenges. On the one hand, their chances of success, which require a lengthy development of the program of reforms, is strongly constrained by the time constraint posed by the very substantial probability that countries fall back into violence within a decade if sustained growth does not develop. As Hausman, Rodrik and Velasco (2008) put it, the search for comprehensive programs of reforms has given rise to "laundry lists of needed reforms" which is extremely difficult to handle in fragile situations due to the very weak institutional capacity and legitimacy<sup>‡</sup>. On the other hand, as Fisher (2006) remarks, the design of comprehensive programs of reforms rarely takes into account that the prevalence of rent-seeking which characterizes the country context in fragile states makes reforms themselves vulnerable to capture by rent-seekers.

More recently, more so-called "interventionist" approaches has been brought to the fore, with the goal of accelerating the transition from conflict to sustained development through programs of support to emerging industries. Its proponents point out that changes in regulations and laws are not bound to produce effective changes throughout the economy. Such approaches include promotion of market linkages, value

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<sup>‡</sup> Pritchett and Woolcock (2010) highlight the existence of "capability traps".

chain products, business associations, microfinance, access to employment and targeted direct intervention in support to single industries or group of households<sup>§</sup>.

The paper suggests a framework to evaluate how different strategies of private sector development impact countries' progress toward achieving a permanent turnaround out of fragility. It highlights that – albeit stemming from different theoretical approaches – both regulatory and interventionist strategies are far from being mutually exclusive do play **significant complementary roles** in handling the dynamics to move out of the low-level equilibrium and achieving a turnaround in fragile and post-conflict situations. The analysis supports the case for an early pro-active engagement of the post-conflict states in private sector development activities.

In **Section 1**, taking as point of departure the way fragility, violence and conflict change economic structures by introducing distortions and changing incentives toward rent-seeking, the paper explores the way in which different private sector development policies support shifting economic systems from predation to production.

We define the post-conflict economy as a rent-seeking society and assume that *sustained economic turnaround* is achieved *when profit-creation incentives are higher than rent-seeking incentives*. Private sector development policies can therefore be categorized into two broader typologies, depending on whether policies

- (a) target reduction of rents and opportunities for rent-seeking, or
- (b) target fostering profit-creating incentives.

The analysis in **Section 2** highlights that on the one hand, regulatory reform aimed at reducing rent-seeking are not less vulnerable to rent-seeking strategies than policies to foster profit-opportunities. On the other hand, policies that see an active role of the state in the development process can be designed as to minimize capture by rent-seekers.

**Section 3** briefly discusses the implications of the framework for international development assistance and highlights the complementarities of private sector development strategies. It suggests that while most of the private sector development

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<sup>§</sup> See DCED (2008) for a review.

policies target rent-seeking reduction, policies targeted at encouraging profit-creation can play a meaningful role in achieving sustained economic turnaround. **Section 4** concludes.

## 1. Economic Turnaround as a Process of Structural Change

### *i. Defining Economic Turnaround*

We owe the concept of “turnaround” to Paul Collier. A country is deemed “in turnaround” when policies, institutions and governance that have improved beyond the [World Bank] threshold for a failing state<sup>\*\*</sup>, and kept beyond the threshold for at least two consecutive years. Achieving sustained turnaround is hence a precondition to permanently exiting fragility.

Chauvet and Collier (2008) have investigated the conditions under which turnaround is more likely. Data shows that the likelihood for a post-conflict country to turnaround increases in the presence of a higher proportion of population with secondary education, decreases with population density and with higher level of resource rent relative to the GDP. The same research shows that countries presenting an important resource rent are less likely to achieve sustained turnaround; financial assistance also presents a slightly negative coefficient while technical assistance is significantly positive.

While the literature has established the importance of sustained economic development to achieve “turnaround”, we’ve not encountered a systematic exploration of “*economic* turnaround”.

This paper attempts to use the concept of ***economic* turnaround** to explore the effect of private sector development on achieving sustained turnaround. For this purpose, we find Chand (2010) definition of economic turnaround a very valid starting point: incentives to production need to be stronger than incentives to predation. We operationalize this view by defining *economic turnaround* as following.

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<sup>\*\*</sup> As expressed by the World Bank Indicators of Country Policy and Institutions Assessment (CPIA).



*Definition of Economic Turnaround: the state of the economy where incentives to profit-creation are higher than incentives to rent-seeking<sup>††</sup>.*

On this basis, we elaborate a framework to explore how policies foster economic turnaround by incentivizing production of rent-seeking.

We move here on a ground where the literature is scant. Economic models of conflict are mostly focused on exploring the drivers of conflicts (on not the drivers of economic turnaround), exploring contests on a given resource base, and trade-offs between production and violent activities. Collier and Hoeffler (2004) grievance versus greed model of civil conflict highlights the centrality of economic incentives (greed) in causing and sustaining protracted civil wars. The model was elaborated from an earlier justice-seeking vs loot-seeking model (Collier and Hoeffler 1999).

While having established greed as a driver of conflict, the literature has not investigated how greed itself influences the dynamic of economic turnaround in the aftermath of conflict. Collier and Gunning (1995)<sup>‡‡</sup> come close by suggesting the concept of “*opportunism post-conflict*” and pointing to the wide monopolistic rents created during conflict. That analysis concludes that policy be focused at making markets as competitive as possible, through deregulation, improved transport, and improved market information. The recommendation rests on the underlying assumption that competition will reduce rents to normal profit level, reducing the attraction of wartime traders. Accordingly, once the appropriate policies to reduce opportunistic behavior are applied, and regulation appropriately adapted, economic growth will arise, and sustaining economic growth will be a matter of controlling for the risk of violence still present in the fragile society and building the necessary institutional capabilities. Market forces will drive the economy into a sustained economic turnaround.

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<sup>††</sup> This paper does not provide an empirical testing of this definition. Admittedly, this definition implies a certain degree of faith on power of the “invisible hand”: while most of the paper reject such faith in fragile contexts – and actually point out that such faith still predominates in most of private sector development policies - we believe it is a reasonable assumption to assert that, when incentives to profit-creation becomes dominant, the conditions are set for the rent-seeking nature of the post-conflict societies to be overcome, and for a sustained turnaround to take place. We leave however open the possibility that future empirical research might show that profit-creation incentives might need to be above a much higher threshold for economic turnaround to self-sustain. The framework developed in the paper is not dependent on the effective threshold level.

<sup>‡‡</sup> In Azam *et al* (1995).

The literature lacks a systematic focus on the relevance of the important predatory and rent-seeking attitudes that are present in the fragile and post-war economy. This paper suggests a framework that aims at filling this gap. Starting from a definition of post-conflict societies as “rent-seeking” societies, we’ll explore the effects of policies on fostering economic turnaround.

Unlike other frameworks, in which agents face a trade-off between production and conflict, we suggest that **agents face a trade-offs between lively-hood activities:** agents have incentives to choose between rent-seeking activities and productive activities<sup>§§</sup> (profit-creation)). While the literature includes incentives to resorting to violence as endogenous, our framework takes resorting to violence as *exogenous*. We introduce violence and conflict in the framework in two ways:

On the one hand, conflict and violence defines the starting point of the economy as “entrenched rent-seeking society”. On the other end, the link to conflict still remains latent through the recognition that failure to foster economic turnaround results in persistent fragility that can tilt the equilibrium back from production to violence. Based on the evidence that failure to foster economic turnaround dramatically increase the risk of resorting back to violence, resorting back to violence enters our framework not as driver but as the result of a “failed turnaround”.

ii. *Rent-seeking VS production and profit-creation*

Most of the analyses on post-conflict economies focus on the behavior of agents, and most notably on the trade-off between violence and production, with very limited focus on the economic structure of the country, which is only considered in the background. While they provide a good framework to analyze the dynamics of fragility and conflict, they do not provide detailed guidance on the different effects on incentives of policies aimed at supporting economic turnaround. For the purpose of this paper, we adopt a different view, taking the effect of protracted conflict and violence on economic structure and incentives as our point of departure.

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<sup>§§</sup> See Neary (1997) for a review of rent-seeking models and economic models of conflict.

We take violence as exogenous. Economic structure and incentives are endogenous. We consider violence as both the ex-ante (series of) event(s) that took place at time  $T_0$  that generated the economic structure and incentives presents at time  $T_1$  (identified as the start of the process of reconciliation) and the event that may take place within time  $T_2$ , with a  $y\%$  of probability to occur, if the state does not enter sustained economic turnaround and escape fragility status. We also assume that amidst the process of reconciliation, limited violence and pervasive insecurity persist and affect the economy well after  $T_1$ . Economic turnaround affects negatively the probability of renewed sustained violence (type  $T_2$  events), which might imply falling back into conflict. By increasing resilience economic turnaround increases the probability of a successful achievement of the reconciliatory process and contributes to a definitive escape from fragility in the longer run.

We take the effect of protracted conflict on the economic structure and incentives as starting point. Besides human losses and capital losses, conflict also deeply disrupts the economic structure of a country by impacting its factors endowment, damaging the hard infrastructure and the soft infrastructure of the economy, weakening the capacity, the authority and the legitimacy of the state, jeopardizing property rights and rule of law (if at all pre-existent). While protracted conflict highly disrupts the economy (stalling private investment and exports, destroying livelihoods and driving down wages [both in the accounted and unaccounted sectors] and driving up prices) economic activity does not halt, but goes through a transformation instead. The state shifts its focus toward increased military spending, and the private sector maximizes short-term gains and rents. Long-term investment is halted, and firms shrink and lose those job-skills that supported higher wages<sup>\*\*\*</sup>. People are driven into subsistence (most often informal) activities. As a result, incentives to predation are higher than incentives over production.

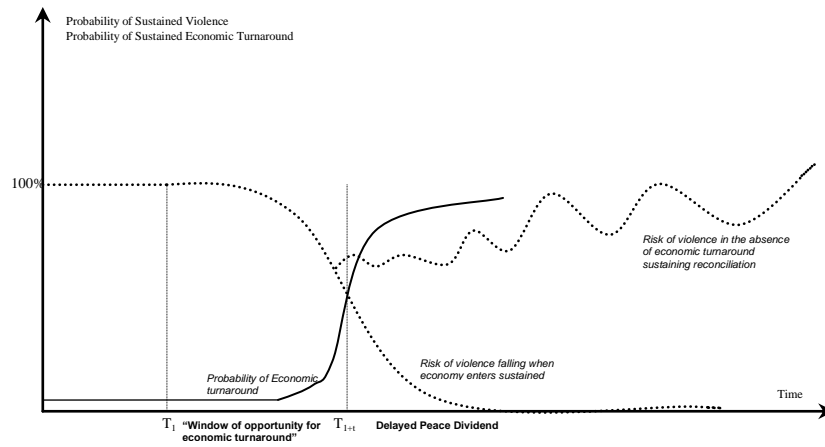
Structurally, conflict induces inter-sectoral resource reallocations (Azam *et al*, 1995). Sectors like manufacturing, which depend on immobile assets and capital, and on functioning markets for both production inputs and outputs, are particularly vulnerable and are characterized by output collapse. Other sectors, like construction and livestock, are affected by shocks of the demand.

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<sup>\*\*\*</sup> Collier (2009), p. 93.

The resulting state of inefficient regulation, large illegal economy, trade barriers, delinquency, state budget poorly structured and executed, unreliable commercial laws and ad-hoc enforcement of property rights, power concentration, lack of accountability, politics of patronage, embezzlement of public funds, excessive level of expenses in some sectors (military), corruption, and exploitation of natural resources rents can be categorized into the broader feature of symptoms of the presence of a deeply changed set of incentives and **structural rent-seeking**<sup>†††</sup>.

Incentives developed in the war economy (during the  $T_0$  period) persist well into the post-conflict transition ( $T_1$ ) making the likely-hood of further sustained violence (at time  $T_2$ ) highly likely.



At  $T_1$ , when the process of reconciliation begins, the economic feature of the country is essentially still very much one of a predatory state, where appropriation of income via rent-seeking is endemic and structural. Predation can extend to both legal and illegal activities, and takes the form of trafficking in illegal commodities (drugs, arms), overpricing of basic staples, perception of tolls at road-blocks, corruption in delivery of basic services, exploitation of natural resources through coerced labor, unavailability of credit at acceptable interest level. The rent-seeking nature of the society present at time  $T_1$  is independent from whether conflict has generated such a situation, or whether a pre-

<sup>†††</sup> Collier (1999b) refers to “opportunistic behavior” and “encroachment of monopoly”. As life tends to be less predictable people shorten their time horizons, changing the calculus of opportunistic behavior. Societies become opportunistic, affecting business practices, impact profits and increasing opportunistic behaviors.

existing predatory state has been itself the cause of sustained violence and conflict during the  $T_0$  period. The resulting rent-seeking societies<sup>†††</sup> extend from the state into the private sector.

When not already pre-existing prior to the conflict, entrenched incentives to rent-seeking are directly created by negative effects of sustained violence on the production and distribution chains, causing insufficient supply of key goods, higher prices, which determines a natural rent for the few remaining producers and sellers of goods. When conflict, violence and insecurity disrupt substantially and permanently production and distribution, quantities cannot respond to price increase, generating distortions that makes rent seeking become inherently part of the economy<sup>§§§</sup>, affecting it in ways not dissimilar to monopolistic rents, or to “institutional rents”<sup>\*\*\*\*</sup>.

The existence of profiteers of war and violence surplus, which extends to rebels, traders, businessmen and criminals, has been effectively described by Collier (1999), who has also sketched how the play out of those incentives might delay reaching a peace-agreement<sup>††††</sup>. This effect extends to private firms as well. Research by Guidolin and La Ferrara (2004) using a continuous indicator of tension shows that moderate levels of conflict can be beneficial to some private firms, while extremely lower level of tension reduce their abnormal returns. This paper focuses on the persistence of this effect well after peace agreements are signed, and representing one of the major obstacles to entering sustained economic turnaround.

By permanently reducing the level of production and disruption cross-border flows, destruction of infrastructure creates a *persisting barrier at entry* that sustains a monopolistic “post-conflict and violence” profiteer’s rent focused on capturing transfers and earning income not directly related to productive activities.

Individual efforts are directed at maximizing value generate social waste rather than social surplus, redirecting the expenditure of scarce resources towards rents,

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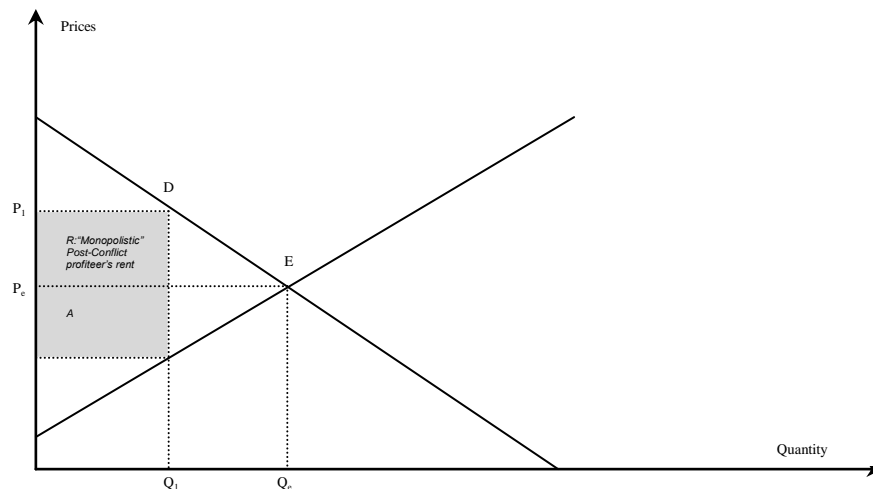
<sup>†††</sup> As intended in this paper, “rent-seeking society” is not meant to refer to the volumetric importance of rents generated in the economy, rather the pervasiveness of rent-seeking behaviors, determined by the “short-termism” of agents, both public and private, in fragile states.

<sup>§§§</sup> As such, economic agents tend to seek rents generated by market monopolies, natural resources rents and rent based on transfers (through the political mechanism). [For a full typology of rents see Khan 2000, p. 35].

<sup>\*\*\*\*</sup> See Lin, Cai and Li (2003: 210) for a definition of institutional rents.

<sup>††††</sup> Collier builds on his analysis to advocate policies to reduce profits from conflicts.

captures and transfers<sup>††††</sup>, instead of investing in means of production. Prices and output level are distorted and generate substantive incentives to rent-seeking. The underlying risk of violence and insecurity keeps the level of output and prices at distorted level, making *rent-seeking behavior* an inherently feature of economies in fragile states, and a major principal cause for sustained poor economic performance<sup>§§§§</sup>. While abandoning rent-seeking behavior would generate obvious long term “peace-dividends” (by pushing the equilibrium from *D* to *E*), the prisoner’s dilemma nature of the situation let rent-seeking remain a deeply entrenched reality well-after a peace-settlement has been reached. In fragile setting, agents do not perceive *E* has a credible level of activity, and are encourage to invest in activities that safe-guard their (post-conflict) rents and keep the equilibrium to *D*.



The rent-seeking based economy is compounded by very strong rent-seeking and predatory incentives within the government institutions themselves. Fragile states fail to provide instruments and institutions which can adequately restrain rent-seeking. Absence of rule of law, property rights and lack of infrastructure, as well as insecurity, violence, expropriation and corruption determine an increase profitability of rent-seeking relative to profit-creating activities. Government activities are themselves an important source of activities that can be appropriated by rent-seeking, indirectly making the state into the

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<sup>††††</sup> Buchanan and Tullock (1980).

<sup>§§§§</sup> Rent-seeking societies are also characterized by talented people avoiding becoming entrepreneurs and joining the government bureaucracy, the army, or other organized groups (Tullock 1967) contributing to a negative impact on growth (Murphy, Schleifer and Vishny, 1991).

“supply side” of rent-seeking. Political systems therefore come to reflect self-interest, interest groups, control over prices and quantities.

As a result, in fragile states incentives to rent-seeking are typically higher than incentives to profit-creation. The income generating function of rent-seeking ( $f_r$ ) presents a higher profitability than function of profit seeking ( $f_p$ ), and the factors endowment ( $r_R$ ) devoted to rent-seeking is higher than the part devoted to production ( $r_P$ ). Equation [1] is derived from Fisher (2006):

$$f_r(r_R) > f_p(r_P) \quad (1)$$

## 2. Analysis of Policies to Foster Economic Turnaround

### *i. A Taxonomy of Policies to foster Economic Turnaround*

From an economic structure point of view, sustained economic turnaround implies entering a dynamic of structural change. Following Chand (2010), we consider that economies enter sustained economic turnaround when incentives to production are higher than incentives to rent-seeking. This paper does not develop a complete formal model, as our purpose is not to explore the effects on the possibilities of production (which we assume are negative), rather more simply, to provide a **framework to categorize different policy approaches to foster economic turnaround**.

Following Fisher (2006), a decline in relative importance of rent-seeking compared to profit-creation may originate either from:

- a. Improved ability to generate income from productive sources, i.e. an increase in  $f_p$  to  $f_p^*$ , which requires a change in the profitability of the function, or in the composition of the factors devoted to production,  $r^*_P$ .

$$f_p^*(r^*_P) > f_p(r_P) \quad (2)$$

- b. Reduction in the profitability of rent-seeking (change in  $f_r$ ), which can be achieved either through reforms that decreases the amount of rents that can be extracted or by increase the cost of rent-seeking (effective in particular when rent-seeking is associated with illegal activities and corruption).

From the proceeding, a categorization of reforms to foster economic turnaround can be derived, depending on which of the four parameters are aimed to be influenced by policies:

- I. *Business environment*:  $f_p^*$  policies that increase profitability of  $f_p$
- II. *Structural change*:  $r_p^*$  policies that shifts positively the factors devoted to production \*\*\*\*\*
- III. *Regulatory Reforms*: which encompasses  $f_r$  policies that decrease the amount of rents extracted from activities and  $r_R$  policies that restrict factors endowment devoted to rent-seeking activities.

Most of the traditional body of reforms supported by international organizations and donors aims at reducing rent-seeking, and can be categorized as part of type III of reforms. These strategies aim at curtailing the (negative) influence of the state on the economy to achieve greater efficiency and enhance prospects for growth and welfare by limiting the rents that can be captured through rent-seeking (type III).

The recent renewed interest in private sector development in fragile setting has put emphasis of a new body of Type (I) policies, intended to increase the profitability of engaging in business activities. More recently, Type (II) policies, grounded on structural change, have also arisen (Lin (2009), Lin and Monga (2010)).

### iii. *Analysis of Policies to Foster Economic Turnaround*

The focus on policies aimed at reducing rent-seeking has a direct affiliation with the traditional rent-seeking literature arisen in the seventies, which has been assuming a

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\*\*\*\*\* It includes re-affecting state expenses towards economic priorities. A key example is reduction of spending on the military. Collier (2006) discusses the benefit of such a reduction.



systematic negative impact of rent-seeking on the possibility of production. Focus on the negative effects of rent-seeking has culminated with Krueger (1974) demonstrating that the costs generated by rent-seeking attitudes themselves are higher than the net wealth loss due to the rent itself. This approach rests on the strong assumptions that on the one hand rent-seeking almost exclusively generates net social wealth *losses*, and on the other hand that market driven profit-seeking activities can rise once the negative effects of rent-seeking are dampened.

Recent research investigating the relation between rent-seeking, state functions and violence put into question the assumption of exclusive negative effects of rent-seeking. North *et al* (2009) suggests that when violence impacts negatively rents, maximization of rents supports arrangements that reduce violence, and induce cooperation. Rents are therefore an integral part of the institutions that support the reconciliation process. The pervasive rent-seeking incentives that govern societies at time  $T_1$  which need to become less prevalent than profit-creation incentives in order to achieve economic turnaround, are also at the base of those “Limited Access Order” institutions described by North *et al*<sup>†††††</sup>. Rent-seeking can support a virtuous cycle that results in political and economic coalitions to allow joint exploitation of rents by elites, and rents are therefore heart of “limited access” institutional arrangements<sup>†††††</sup>. DiJohn and J. Putzel (2009) find that peace is more likely when elites have access to resources, and therefore rents, pointing to the existence of a political dynamic of growth.

While rent-seeking is instrumental in halting sustained violence, and giving rise to an embryonic stable state at  $T_1$ , structural rent-seeking also presents economic inefficiencies compromising the chances of sustained economic turnaround. Rent-seeking societies show a low degree of resilience, and are highly vulnerable to both internal and external shocks, which set off a vicious cycle that restores higher level of violence ( $T_2$  type of events). As a result, the link between peace and economic development assumed

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<sup>†††††</sup> The “limited access order” framework suggested by North *et al* (2009) is a valuable to provide insights into the dynamics of bursts of violence in fragile states. It also highlights again the importance of reaching a higher level of (institutional and economic) development in order to avoid the observed phenomenon of peace breaking again into violence within a few years.

<sup>†††††</sup> A striking example of importance of rent-seeking in generating equilibriums can be found in the abnormal returns of “Angolan” stocks, which experienced a significant drop in correspondence to the end of the conflict in 2002.

by neo-classical models is non-existent, with both the state and the private sector engaged in exploiting stability to extract rents instead of pursuing profitability within economic activities.

North *et al* (2009) analysis is limited to the role of rents in institutions, and do not explore incentives to net value production in rent-seeking societies. Khan (2000) suggests a model of rent-seeking that includes positive spillover of positive social benefits, however production is not directly integrated into the model, and only appears as the additional part of the social benefit that rent-seekers aim at redistributing among themselves. Khan's model does not clearly differentiate between (rent-seeking) incentives that lead to predation from incentives (among which rent-seeking itself) that lead to production. For the purpose of this paper, and for exploring the type of policies that lead to sustained economic turnaround, the distinction between rent-seeking and profit-creation is essential<sup>§§§§§</sup>.

*iv. Policies aimed at curtailing rent-seeking - Type III Policies*

Policies aimed at curtailing rent-seeking include instruments to limits rents extraction that attempts to reproduce features of developed countries' regulatory frameworks. Type III policies aim at removing protection to rent-seeking activities most notably by attempting to remove barriers, generate competition, and adjusting prices. A subset of Type III policies aims reducing the allocation of factors of production into rent-seeking activities by establishing barriers at entry to rent-seeking activities. Examples are the enactment of new laws, or strengthening the enforcement of existing laws, to combat the type of crime related activities often present in post-conflict situations. Other examples are market policies to prevent illegitimate supplies from gaining access to legitimate channels.

Efforts to reduce rent-seeking are limited in the efficacy by the strong oppositions to reforms by rent-seekers (Buchanan 1980), and the capacity of rent-seeker to capture reforms themselves to generate more rents (Hellman, Jones, and Kaufmann, 2000). The

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<sup>§§§§§</sup> Khan's assumptions on the distributor dynamics around profits is however useful to help clarify why simply rent-reducing policies are not by themselves conducive of economic turnarounds, and might actually have destabilizing effects on the internal dynamics of fragile state's institutions.

chances of reforming established rents appear to be stronger when the reformer is motivated by factional interest (redistributive motives) than when motivated by the general interest perspective of diffusing welfare throughout society. Tollison and Wagner (1991) stress that this effect is particularly strong when reforming *established* rents, while policy efforts directed towards prevention of future distortions and potential rents are more efficient than reforms aimed at eradication of existing rents.

Types I and III strategies rest on the assumption that in the targeted countries, rent-seeking by the state can be disentangled from rent-seeking behaviors in the private sector so that reduction of the influence from the state can have positive effects on the private sector and that reduction of (negative) influence of the state over the private sector is a priority over developing the state. This is likely not the case. The literature on rent-seeking has established the existence of a symbiotic and self-reinforcing relationship between predatory states and the rent-seeking economy. There is no evidence to support the hypothesis that curtailing the negative influence of a predatory state is *sufficient* to ensure that a rent-seeking society evolves into a production-driven society.

On the other hand, research points to the need of taking into account effects on the dynamic of the society in the design and implementation of policies aimed at reducing rents to avoid adverse effects of the fragile political and social equilibrium. Recent insights from case studies within the institutional approach (North *et al*, 2010) point out that rents constitute a powerful element for holding together coalitions in fragile limited access orders. As a result, policies designed to forcefully reduce rents might increase the risks of ushering in new disorders and violence, while at the same time they do not necessarily increase profit-creation competition in the market.

Approaching rent-seeking societies by curtailing the (negative) reach of the state, and aggressively pursue type III strategies aimed at reducing rents is not sufficient to achieve sustained economic turnaround, and presents risks of destabilizing fragile societies, and rent-seeking non-violent agreements between parties<sup>\*\*\*\*\*</sup>.

The key importance, and also the key limitation, of type of policies in fostering economic turnaround lay in their *complementarities* with other type of interventions.

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\*\*\*\*\* Post-conflict Cambodia resisted international financial institutions' advice to downsize civil service, as the political coalition arrangement under the peace accords was based in part on raising the size of the civil service to absorb large numbers of the incoming parties' functionaries (OED 1998).

While weak or absent rule of law strongly compromise the capacity to effectively seeking profit-creation, enactment of rule of law alone, and unilateral restriction of entry to rent-seeking activities alone is bound to produce an increase in excess capacity in particular unemployment.

v. *Policies aimed at increasing profitability of production factors (Type I policies)*

Type I policies aim at increasing profitability of factors of productions. Under this typology fall policies aimed at removing regulatory obstacles to activities through strengthening the legal protection of property, making commercial contracts legally binding, and reforming doing business parameters.

The strong incentives to rent-seeking that characterizes post-conflict setting severely limit the effectiveness of business climate policies. Hallward-Driemeier, Khunjush and Pritchett (2010) shows that African firms do not cope with policy rules, rather they face deals. As a result their research indicates that the gap between de jure and de facto respect of “Doing Business” parameters grows when a formal regulatory burden is added. While “Doing Business” reforms allows improving profitability de jure, in weak institutional environments, the actually implemented policy actions are substantially different, resulting in failing to reduce firms’ uncertainties.

Type I policies present a higher chance of achieving the desired effect when business environment reforms are aimed at increasing foreign investment. On the other hand, business environment reforms can facilitate repatriation of investment in those countries that present a substantial amount of private savings hold abroad. However, both foreign investment and repatriation are less likely if economic turnaround is not underway, i.e. if incentives to profits have not yet become dominant. Until then, private national entrepreneurs are more likely to factor in policy uncertainty<sup>†††††</sup>, and hold part of it abroad, indirectly supporting a “rent-seeking” approach to business.

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<sup>†††††</sup> Collier and Gunning (1995) in Azam *et al* (1995).

vi. *Policies aimed at increasing the part of factor endowments devoted to profit-creation (Type II policies)*

In very recent years, policies to foster private sector development have expanded toward more interventionist approaches to encompass work on industrial sectors. A few donors have developed post-conflict value-chain development (USAID 2008). In view of the centrality that structural transformation and industrialization play in fostering productive incentives (and achieving higher incentives of production over rent-seeking) fostering structural transformation deserves an important place in the tool-box of policies to foster economic turnaround. However, in fragile and post-conflict situation, the difficulties encountered in structural change policies, are compounded by the extremely weak institutional setting, and the presence of a rent-seeking societies.

Type II policies aim at increasing the part of factor endowments devoted to profit-creation by fostering economic structural change. Type II policies are traditionally mostly conceived as “horizontal” policies, i.e. uniform measures that do not discriminate across economic sectors, but aim at creating the basis for development of economic activities across all sectors.

In practice however, such policies tend to favor sectors in which the corresponding binding constraint is perceived as the strongest by agencies, donors and the government. This prioritization has been based on pragmatic approaches on the ground, which rely mostly on donors and governments’ preference or comparative advantage in sectors of interventions, positive experiences from other countries, and sectoral studies. Despite the existence of forms of high prioritization in the field, type II policies are not underpinned by a framework of systematic policy prioritization. Rodrik (2004) qualifies it as “spray-gun approach”. There is a widespread reluctance to have governments engage in any form of “picking winners” in view of the danger of active development policies aimed at targeted sectors being captured by rent-seeking.

Critics point out that granting the government greater scope is bound to increase rent-seeking, as rent-seeking and informational costs are a positive function of government scope, and point to cross-industry studies, which suggests that traditional industrial policy instruments do not lead to substantial productivity benefits. Rodrik

(2008) points out that the market failure argument for government intervention is overwhelming and that the informational and rent-seeking costs of government intervention in structural change can be ameliorated through appropriate institutional design of policies (embeddedness, carrots-and-sticks, and accountability).

Policies that aims at increasing the endowment devoted to profit-creation (type II policies) may play an important complementary role to type I and III policies.

If appropriately designed, structural transformation policies present a high potential to accelerate economic turnaround, hence reducing the risks of a return to violence due the vulnerability generated by protracted economic stagnation. To effectively support economic turnaround, Type II policies should be designed as so to maximizing their positive effects on profit-creation, minimizing the potential rent-seeking effect.

Lin (2003) suggests that minimization of opportunities for rent-seeking can be obtained by limiting the state's facilitation role to those sectors that are compatible with the country's (latent) comparative advantage. Type II policies hence require a very early identification of growth sectors that present this favorable profit-creation/rent-seeking profile. On the other hand, Type II policies will require adopting measures<sup>+++++</sup> to protect the (quasi-)rents generated by first movers in the new sectors<sup>§§§§§§</sup>.

### **3. Sustained Economic Turnaround and the Role of the State**

In the preceding section we've reviewed the typology of policies of private sector development. We've highlighted the strengths and limitations of Type I and Type III policies, concluding the business environment policies and regulatory reforms are not sufficient to generate the massive shift of incentives needed to enter a dynamic of sustained economic turnaround. The bulk of the current policies rests on a sets of regulatory reforms that aims at limiting the capacity of extraction of rents (type III policies) while interest on policies aimed at shifting factors toward productive and profit-creation (type II policies) has arisen only recently.

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+++++ Type I and Type III policies.

§§§§§ This definition is by Brian Levy, 2010.

In the praxis of agencies and government, the three types of policies have come to be applied along a typical timeline that aims first at limiting extraction from illicit activities and limit rent extraction from activities through regulations (type III policies), and improve profitability of activities by improving business climate to foster foreign investment (type I policies). Type II policies are being applied on a later phase and mostly conceived as homogenous. Such sequencing reflects an approach to rent-seeking societies mostly based on the assumption that limiting rent-seeking (in particular from the state), can provide a fertile ground for profit-creation to arise.

In view of the difficulties of productive activities to arise in a rent-seeking society, and in view of the important role that some rent-seeking plays in early stabilization to reduce violence, the mix and sequencing of reforms aimed at reducing rent-seeking and increasing profit-creation deserves further research.

In particular further research need be devoted on the effects of reducing rents on states in their early stages, and the role the state can play in fostering profit-creation.

We believe our findings are consistent with recent research showing that it is the capacity to generate “good policies”, and not “good governance” per se, that increases the likelihood of a positive economic outcome (Meisel and Aoudia, 2008). Our analysis also supports Collier (2006) conclusion that credible long-term economic vision contributes to shift incentives to longer term, more toward profit opportunities and less toward rent-seeking short term focus.

As pointed out by Rodrik (2004) however, while economists have perfected tools to evaluate policies ex post, the ability to design growth strategies remains extremely embryonic. A promising approach to type II policies has recently been elaborated by Lin and Monga (2010), who provide a framework for growth identification built on the need to maximizing impact of profit-making, and minimizing the risk of the rent-seeking that has accompanied structural change reforms in the past.

#### **4. Conclusion**

Economies in fragile situations are permeated by the negative effects of entrenched rent-seeking. However, engaging in aggressive policies of rent-reductions is

per se not enough, and presents possible destabilizing effects over the fragile social order. Even in fragile situations achieving a sustained level of economic growth is possible only through structural change and finally through achieving a minimal level of industrialization. As Syrquin (1988) notes, it is not a question of whether industrialization is necessary, but only “*when and in what manner it will take place*”. Hence, the importance of laying out groundwork to achieve a new development trajectory (UN 2009), and create the conditions for the future structural change, right at the start of process of reconciliation.



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