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PRIVATE SECTOR DEVELOPMENT IN COUNTRIES PROGRESSING TO PEACE AND PROSPERITY

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Executive summary

This report focuses on the specific challenges and opportunities of states that are making two challenging concurrent transitions, away from both extreme poverty and from conflict. First, they are 'countries where the longer term prospects of the poor to escape poverty are overall good, but not necessarily secure or sustainable, and at risk of development reversals' (Dercon and Lea, 2014). Second, they are affected in various ways by conflict and instability and are addressing the challenges of maintaining peace. This report is based on studies in six such countries with the aim of providing evidence, conclusions, and recommendations on the developing of private sector development (PSD) strategies in such places. The countries studied are Egypt, Ethiopia, Lebanon, Nepal, Myanmar, and Sudan. The report builds on previous research, including an earlier study under the UK Department for International Development's (DFID) Policy Research Fund looking at the challenges of PSD in lower-middle-income countries (Stanbury-Davis., 2016).

The regional setting for these countries has significant implications both in terms of economic development and conflict. Conflicts in a country's neighbours will mean that previously prosperous trading partners disappear and also that trade routes to the wider region are disrupted. Conflict in a country's 'neighbourhood' may also have serious spillovers, for example in creating large numbers of refugees, which in turn have a destabilising effect domestically. Furthermore, fear that regional instability could affect national stability has significant impacts on domestic politics and the decisions that are made.

At a domestic level, these transition countries face serious challenges. Most obviously they are typically run by oligarchic elites that operate more for their own benefit than for that of the country as a whole. Much political energy goes into managing the interests of these elites rather than into focusing on and addressing the country's development challenges. This challenge of political focus is aggravated by often-challenging administrative and legal processes. Public officials are frequently appointed on the basis of connections rather than qualifications, meaning that, even when reforms are attempted, the capacity to see them through is often lacking.

These national-level challenges spill over into the private sector, restricting its capability to grow effectively and to create jobs and income. A core challenge is that elite control at a political level also exists in the private sector, with the result that key sectors and important companies are controlled by politicians, the military, or others connected to the ruling regime. This has a number of effects. First, these companies frequently fail to deliver often-important services to the wider economy and stymie reform. Second, it means that large parts of the private sector may be operating in an opaque manner. Third, there is often a fear in the wider private sector that if they grow too big, or identify an interesting new commercial opportunity, this will be snatched up by elites. Companies also face significant challenges with the regulatory environment, with laws which are either highly problematic or not properly enforced. The private sector is also typified in these countries by a 'missing middle'. There is a lack of medium-sized companies to link small and medium-sized enterprises (SMEs) to opportunities with larger firms. Regional inequities can mean that commercial activities take place predominantly in a small number of large commercial hubs, with little going on in neglected, often rural, settings.

It is clear that, for PSD practitioners, the usual toolbox of solutions is not sufficient to meet the challenges that exist. These include firstly a focus on macroeconomic stability, which though technically not part of a PSD portfolio is necessary to provide support to countries responding to significant instability. Reform of the regulatory environment is a key challenge in these countries, but making change happen is complicated by elite control and poor implementation capacities on the part of public servants. As a result, much PSD effort goes on firm-level activities, to support companies to survive and expand even in a problematic wider context. It is also clear that in these contexts, PSD programming needs to be very closely tied to other streams of development activity, in particular interventions on issues of governance and peacebuilding. However, factors such as education and infrastructure are also important to the longer-term development of the private sector, and therefore PSD needs to link closely to activities in these areas too. Programming needs to be flexible and adaptive and responsive to change as it happens, as well as needing to pick up and exploit opportunities as they arise. The combination of conflict and middle-income challenges often make the reform agenda seem huge and undoable. By focusing on what might be relatively small areas of reform, practitioners are in a better position to make change happen.

In fragile contexts, the private sector is inextricably interwoven into the conflict dynamics. PSD practitioners need to maintain clear sight of these dynamics in the places where they operate, while those working on other areas of development also need to understand the private sector and see PSD activities as a priority. Economic activity will not solve conflict, but nor can PSD and broader economic growth wait until conflict is resolved. PSD activities in middle-income countries need to focus on several different aspects of 'the private sector' – ranging from large international investors and diaspora businesses to smaller SMEs. Each will have a different role to play, and different interests: all need to be accommodated. Practitioners need to be pragmatic in their approach, and base what they do on detailed and ongoing conflict and political economy analysis. These are crucial to ensuring that interventions are focused on the right issues, and to identify where leverage for change might exist even in a generally challenging context.

This study shares many of the conclusions of the 2016 study looking at lower-middle-income countries. These include: challenges with elite control and the impact this has on the growth of the private sector; a poor and opaque regulatory environment; and the need to see PSD programming as part of an overall approach in a country, in particular with interventions focused on good governance. However, this study has also identified significant additional issues stemming from the addition of conflict dynamics. First, the regional context in which a country exists is extremely important, meaning programming needs to consider the regional as well as the national context. Second, the implications of conflict may lie as much in the fear of instability as much as in the reality of it. Third, and most importantly, the conflict dimension means that the stakes are much higher. The skein of interests and networks that prevents a fragile situation getting worse is complex and often opaque. Development programming needs to be very sensitive and undertake detailed and appropriate analysis to ensure that interventions improve the situation or at the very least do not destabilise the *status quo*.

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List of abbreviations

ADB	Asian Development Bank
CDC	Commonwealth Development Commission
DAC	Development Assistance Committee
DFID	Department for International Development
EAOs	Ethnic armed organisations
EPI	Economic Policy Incubator
FCS	Fragile and Conflict-Affected States
FDI	Foreign direct investment
GERD	Grand Ethiopian Renaissance Dam
HEART	High-Quality Technical Assistance for Results
IFC	International Finance Corporation
IMF	International Monetary Fund
MCRB	Myanmar Centre for Responsible Business
OECD	Organisation for Economic Co-operation and Development
PIDG	Private Infrastructure Development Group
PPD	Public–Private Dialogue
PSD	Private sector development
SDG	Sustainable Development Goals
SME	Small and medium-sized enterprises
SWFs	Sovereign wealth funds
UNHCR	United Nations Refugee Agency
USAID	United States Agency for International Development
WBG	World Bank Group
WEF	World Economic Forum

1 Introduction

The international development community is seeking ways to address two particular challenges: how to support development in middle- and lower-middle-income countries, and how to deal with fragile and conflict-affected states. This report presents the findings from a research project that studied countries which fall into both of these categories, i.e. which are both middle- and lower-middle-income and fragile. The research was undertaken between November 2017 and June 2018 and was supported by the DFID Policy Research Fund. It was primarily qualitative in nature and builds on a previous research project supported by DFID (Stanbury-Davis *et al.*, 2016) looking at the challenges facing PSD practitioners in lower-middle-income countries progressing to prosperity. This research project incorporated both desk-based research and in-country case studies of six locations: Ethiopia, Egypt, Lebanon, Myanmar, Nepal, and Sudan. The objective of this research, as defined by its terms of reference was ‘to provide evidence, conclusions and recommendations which will guide DFID and other donor organisations in developing PSD strategies for countries progressing towards peace and prosperity’.

The increased focus on the part of the development community on middle-income countries reflects the fact that as many as two-thirds of the world’s poor now live in these countries. Yet these places exhibit a very particular set of development challenges and many become stuck in the ‘middle-income trap’, i.e. they find it hard to progress from middle-income to high-income status. Fragile and conflict-affected states also present very particular challenges. They are significant both in their own right – it is estimated that one in five of the world’s population live in countries that are fragile or conflict-affected – but also because of the wider impacts of fragility: as many as 90% of refugees are displaced because of conflict and instability.

This study consisted of two phases: an initial review of existing literature and then a series of field research trips in each of our focal countries. The review of secondary literature covered two topic areas: first, the literature relating to the role of the private sector in fragile states and the perceived role of PSD in this; and, second, that relating to the challenges faced by middle-income countries, in particular focusing on the ‘middle-income trap’ and the causes of it. The literature on the private sector in fragile states remains relatively slight, with fewer novel additions to the corpus of knowledge than might be expected for such a significant and important topic. With a few notable exceptions – for example, a study by GIZ (Schrade *et al.*, 2016) of the role of PSD and the private sector in active conflict – much of the recent literature merely reviews previous studies rather than explores new ground. By contrast, the literature on the challenges facing middle-income countries is larger and there have been more recent, substantive contributions to the debate.

Selecting case study countries for this study proved complicated. In the first instance was the usual challenge of case study research that no set of cases can ever be representative of all countries in transition and therefore criticism could be made of any country case choices made. However, in the case of this research, a particular challenge was posed by the question of exactly what is meant by a ‘fragile and conflict-affected state’ (FCS).¹ Some countries are obvious – Afghanistan, for example – but lists compiled by international agencies differ. The World Bank list for example is quite binary, with countries being labelled as FCS if they fall below a certain score on the Bank’s country assessment. DFID’s categorisation is more nuanced and lists countries by level of fragility, also including

¹ This issue is explored in greater detail in the next chapter

countries that neighbour fragile states. It was eventually from this list that country cases were selected, focusing on those countries that are listed as either 'medium' or 'high' fragility. From within this list, the following criteria were used to identify case studies:

- **Research risks:** The team collectively agreed that we would avoid field visits to countries in which active conflict would pose a risk to researchers.
- **Proximity to conflict:** While countries with widespread hot conflict were to be avoided it was important to survey countries that are not too far past conflict.
- **Causes of conflict:** Azar's (1990) 'levels of analysis' approach argues that conflict causation can be seen as having international, national, sub-national, and local causations. So far as possible, this study encompassed conflicts that include different levels of causation.
- **Stage of transition:** As in the previous study (Stanbury-Davis 2016), it was important to understand where countries are on their journey to and beyond middle-income status.
- **Different geographies:** The case studies needed to be drawn from different geographies rather than being all from one continent.
- **Regional considerations:** Both the FCS and middle-income countries literature make clear that international links are important. It was important therefore to explore in the field visits the degree to which regional factors were important for countries' economic and stability trajectories.
- **Availability of data:** There is little point in doing a case study if there is little or no information readily available. It was important therefore to choose countries to study where data of a decent standard were available.

This set of criteria eventually led the research team to identify six target countries, drawn from three regions, as follows:

- **Asia:** Myanmar, Nepal
- **Horn of Africa:** Ethiopia, Sudan
- **Middle East:** Egypt, Lebanon

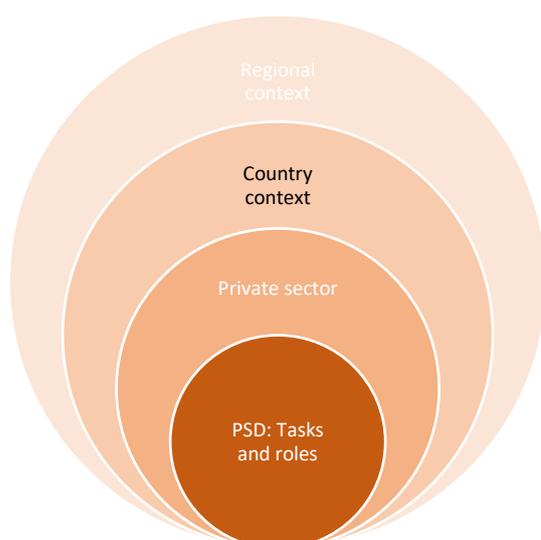
Country research trips took place in spring 2018 and consisted of interviews with key people and organisations in the subject countries. Key stakeholders to engage with were identified before the country mission, with the considerable and welcome support of British embassies and high commissions. These were supplemented by use of the co-called 'snowball sampling' approach, with initial interviewees being asked to recommend others to speak with. To reduce the risk of bias, the team needed to ensure that our interview process reached as broad a cross-section of relevant stakeholders as possible. Typically, interviewees included the following:

- DFID country office, including previous heads of office and advisers as appropriate;
- Other representatives of the UK government, for example Foreign and Commonwealth Office staff;
- Other bilateral development agencies and missions;
- The International Finance Corporation (IFC) and other relevant development banks;
- Representatives of the private sector, including foreign investors, local firms, SMEs, etc.;
- Business membership organisations; and
- Academics and commentators.

The findings of this study were, understandably, multifaceted and complex. To provide a coherent narrative, the research team used the following organising structure to organise the data on each country, and for the study overall:

- **Regional context:** What regional issues are relevant to, and impact on, the target country? This will include both issues relating to conflicts and inter-regional trade and investment.
- **Country context:** What stages are there for countries in their graduation from development aid, and can key 'markers' be identified which allow a judgement to be made on where a country is in this journey?
- **Private sector:** What sort of private sector is most desirable in developmental terms? Which contributes best to its host country's progression? What challenges exist to the creation and durability of a private sector that contributes to wider development?
- **PSD: Tasks and roles:** What PSD modalities work best at different times to create stable states and a developmentally positive private sector? Which of the expanding range of partners are most relevant to deliver which interventions?

Figure 1: Mapping the role of PSD in countries moving toward peace and prosperity



Chapters 3–6 will therefore investigate each of these 'rings' in detail. Each of these analytical chapters, based substantially on the evidence generated by our country case studies, seeks both to assess the issues that have emerged and to make action-oriented recommendations that will be useful to development practitioners. The final chapter of this report then draws together overarching themes and conclusions from the research as a whole.

It is important to also note what this report does not do, and the limitations of its scope. First, and most obviously, as is inevitable with a study based on case studies, what has emerged from the six countries studied may not necessarily hold true for other locations. Second, while this report focuses on lower-middle and middle-income countries and what makes them distinctive, we did not conduct a comparative survey with countries at other stages of development. Finally, it is important to note that this report, though funded by DFID, is intended as a contribution to the development debate as a whole. It is anticipated that its findings (and indeed the questions arising from those) will be useful not just to 'traditional' donors but also to the numerous other actors now in the development space.

2 Research and policy context

This research focuses on two key issues: the role of the private sector in fragile states, and the challenges countries face in moving into, and beyond, lower-middle-income status. This chapter explores the relevant secondary literature and the policy context for both of these issues. Specifically, the aim of this study is to provide evidence, conclusions, and recommendations on the development of PSD strategies in such places.

Increasingly, a key focus of the international development community is on FCS. As was pointed out in a recent GIZ study (Schrade *et al*, 2017), about 1.4 billion people – around 20% of the world's population – currently live in countries in, or prone to, conflict. Moreover, 90% of the more than 60 million refugees worldwide (including internally displaced persons) are fleeing from violent conflict and human rights violations. Thus, many contexts of development cooperation are affected by conflict, violence, and fragility, and accordingly approaches to development cooperation need to consider these circumstances.

At the same time, the international development community is shifting away from its historic focus on the world's poorest countries. It is now clear that if donors wish to reach poor people, then they need to focus increasingly on vulnerable countries where poor people live. In 1990, less than 10% of the world's poor lived in middle-income countries; by 2007 this figure had increased to over 70%. This change is in particular due to the move from low- to middle-income status of five countries: China, India, Indonesia, Nigeria, and Pakistan.

2.1 FCS

Poverty is becoming increasingly concentrated in fragile states. It is estimated that half of the world's people surviving on less than \$1.25 a day are found in fragile states. People in fragile states are more than twice as likely to be undernourished as those in other developing countries, more than three times as likely to be unable to send their children to school, and twice as likely to see their children die before the age of five. In 2013, the World Bank reported that fragile states 'continue to lag behind the rest of the developing world in meeting development goals' (World Bank, 2013).

The donor community has therefore been increasingly focusing on these states from a development perspective, not simply looking at what can be done in peacekeeping and humanitarian terms. The UK government has been at the forefront of these developments, and has a clear focus: 'Work to prevent and respond to conflict and fragility saves lives and reduces human suffering is essential for poverty reduction and progress against the SDGs [Sustainable Development Goals] and it can help to address threats to global and regional stability' (International Development Committee, 2012). Other donors too are focusing their work: at the 2011 4th High-Level Forum on Aid Effectiveness, the major bilateral and multilateral donors committed to the New Deal for Engagement in Fragile States.

2.1.1 What are FCS?

Despite the development community's increased focus on FCS, the definition of exactly what fragility is remains a matter of debate. As World Bank (2018b:) observed, since a list of FCS as states was first developed, it has 'gone through a series of changes in terms of classification. The concept and the list have evolved as the WBG's [World Bank Group's] understanding of the development challenges in countries affected by violence and instability

has matured.’ This also remains a work in progress: a report from the World Bank’s Independent Evaluation Group (2013) observed the need for the Bank to ‘[develop] a more suitable and accurate mechanism to classify FCS’.

Terms such as ‘conflict-affected’ and ‘post-conflict’, while widely used, can be unhelpful given how dynamic are the factors leading to war and instability. As World Bank (2004:8) concluded, ‘post-conflict countries face a 44% chance of reverting to conflict during the first five years following the onset of peace’. The Swedish development agency, Sida, uses what it terms an ‘integrated conflict perspective’ to reflect the challenge that conflict and tensions alter over time (see Figure 2).

Figure 2: Sida’s integrated conflict cycle



Source: Sida (2017)

However, fragility and instability are about more than conflict alone. As the recent report by the Commission on State Fragility, Growth and Development² observed, there are a range of ‘characteristics of fragility, including the lack of basic security, inadequate government capacity, the absence of a properly functioning private sector, and the presence of divided societies’ (Commission on State Fragility, Growth and Development, 2018: 12). Moreover, conflict and/or instability may be geographically limited in any given country. This is true of a number of the countries included in this study: in Myanmar, although major conflict exists in Rakhine, and instability is present in a number of other areas, much of the centre of the country is stable. A similar situation of a stable centre and fragile regions is also true of Ethiopia. In Egypt, the Da’esh insurgency affects the Sinai Peninsula but rarely impacts on the country as a whole.

Nevertheless, it is clear that as some countries become stuck in a middle-income trap, others (sometimes the same ones) are stuck in a ‘conflict trap’. As the Cameron Commission says, ‘fragile societies are typically trapped in a syndrome of interlocking characteristics which makes it hard to make sustained progress’ (Commission on State Fragility, Growth and Development, 2018: 16). The Commission identifies a number of factors leading to this ‘fragility syndrome’. First, such states are often fractured into groups with opposing identities who see their struggles as a zero-sum game. Second, because of the oppositional approach that results, many citizens do not regard the state as legitimate and so do not comply with it. Third, compounding this, the state lacks the capacity to perform basic functions, such as service delivery, citizen security, taxation, and infrastructure. Fourth, identity politics and lack

² This is sometimes referred to as the *Cameron Commission* after one of its co-chairs, former UK Prime Minister, David Cameron.

of state capacity mean that a country has inadequate security, which is manifested in sporadic outbreaks of violence. All four of these problems then compound a fifth: the private sector is underdeveloped so that incomes are low and the economy narrowly based.

2.1.2 The private sector in FCS

A key recommendation of the Cameron Commission is to facilitate and stimulate the private sector, on the basis that 'if the economy grows and drives up living standards, people acquire a greater stake in their society, and state revenues, capacities, and legitimacy all increase' (Commission on State Fragility, Growth and Development, 2018: 20). This conclusion coheres with the wider and growing recognition of the importance of the private sector in FCS. A failure to do so risks undermining a country's longer-term stability. As a background paper to the 2011 World Development Report argued, 'it is important to move away from any argument under which sequencing would imply that security comes first, while private sector development-related reforms come later' (Peschka, 2011: 41). Therefore, as was argued in the 2011 World Development Report itself, 'we need to put greater emphasis on early projects to create jobs, especially through the private sector' (World Bank, 2011:xiii).

According to the Donor Committee for Enterprise Development (2010), the private sector can contribute to FCS in four key ways:

- **Supporting the creation of stability and trust:** by supporting business across ethnic and other conflict divides, companies can help to foster trust and stability in the societies in which they operate;
- **Fostering good governance:** by ensuring that they are themselves well run, companies can underpin the need for good governance in FCS;
- **Developing infrastructure:** companies help to support the creation of both hard infrastructure (i.e. roads, etc.) and 'soft' infrastructure such as business networks and training provision; and
- **Creating economic growth:** the private sector is crucial to the development of a strong economy and economic growth, which provides income to individuals and drives tax revenues for host countries.

However, the private sector can also harm conflict dynamics. Keen (2009) explores the factors that may incline companies to be more or less prepared to engage in peacebuilding. He finds that enterprises engaged in low-technology, high-value commodities are indifferent to peace, provided these commodities remain extractable during conflict. Keen further finds that a minority of businesses – most of them either with access to means of violence or some other direct stake in the outcome of the power struggle that drives the war in question – are more profitable during conflict. Therefore, they may have an interest in preventing the re-establishment of peace: these are businesses, for example, that make higher profits from opportunities in food trading at times of artificially high food prices, arms trading, drug trading, and natural resource exploitation. By contrast, Keen finds that businesses affected by reduced production and weakened local demand during war – mostly in the industrial and agricultural production and services sectors – have the strongest interest in peace.

2.1.3 Different elements of the private sector: different impacts

The 'private sector' is not a single entity but is rather made up of a wide range of very different entities, each of which interact very differently with a conflict context. As Brück *et al.* (2012:4) put it, 'the impacts of conflict are geographically varied and the impact of violent conflict on entrepreneurs and firms will differ across a country or region'. A number of different aspects of the private sector are explored in the literature.

Foreign investors

Historically, views have been mixed regarding the impacts that international companies have on conflict dynamics. Wenger and Moeckli (2003:5), for example, argue that 'corporations have long been accused of causing or exacerbating conflict through their business operations'. Nevertheless, some studies demonstrate that foreign direct investment (FDI) can have positive, beneficial impacts on conflict dynamics. Lee and Mitchell (2012:675) conclude that 'higher bilateral FDI flows between two disputants significantly reduce the chances for escalation to high levels of violence over issues and improve the chances for peaceful management'.

It is often the extractive sector that finds itself in the spotlight in FCS. However, in Bray's (2005:vi) view, larger companies are likely to be unwilling to enter conflict or post-conflict environments because 'in the year or two after the conflict ends, it is rarely worth taking high risks for returns which are, on the scale of these companies balance sheets, likely to be marginal'. However, by contrast, the so-called 'mining juniors' – smaller firms that market themselves to investors on the promise of high returns – are likely to enter post-conflict markets. These companies' risk management processes may not always be as attuned as those of their bigger cousins to limiting their impact on conflict dynamics.

Beyond the extractive sectors, it is frequently those companies in the agribusiness, food and beverage value chains that operate in FCS. According to World Bank (2014), Coca-Cola is one of the 10 companies with the most investments in fragile and conflict-affected situations and offers a number of well-documented examples of development multipliers. Other multinationals such as Nestle, Unilever, PepsiCo, Wal-Mart, Olam, Danone, and DSM are also investing in projects in FCS.

The telecommunications sector is one of the few in the non-extractive sectors to attract sizeable and early investment and to demonstrate high rates of growth in FCS. As Bray (2005:41) points out, 'mobile phone companies have shown themselves willing to move into post-conflict economies as soon as the fighting ceases'. As a result, rapid increases in access to telephony were recorded even in countries with very difficult business environments or with ongoing conflict and a high incidence of poverty. For example, 38% of Afghans and 34% of Sierra Leoneans had a mobile phone subscription in 2010, up from 4% and 14%, respectively, in 2005. The growth of mobile networks was largely driven by private investment, and accessibility increased due to competition.

Banks differ from other sectors in that their exposure is indirect rather than direct. A bank's own footprint in a fragile state may be confined to a small office. However, the exposure lies in funding other companies and projects that are themselves vulnerable to the impacts of conflict. Moreover, the often-problematic legal framework in these countries poses challenges in terms of security of collateral, as well as in terms of the processes of banking oversight and regulation.

Regional multinationals

There are a range of companies that are not known internationally but that invest in countries in their 'back yard'. This category includes, for example, companies from Beirut investing in other countries in the Middle East and companies from Morocco and Nigeria expanding into other places in west Africa. The reason for this careful expansion is that these companies believe they have sufficient affinity with their target markets because of their similarity with their home market. By contrast with global multinationals, these companies may not have as wide a choice of investment markets; nonetheless, they have some flexibility and can scale up or scale down their activities in a range of countries depending on particular circumstances. They, too, may have options to leverage assets in stable countries to facilitate business in fragile states. For example, a bank may use collateral in western Europe or one of the Gulf States to secure a loan in somewhere like Iraq.

Local companies

Avis (2016:5) argues that 'the local private sector is considered to have a range of motivations for wanting to address fragility and conflict' because, unlike international companies, they have no alternative but to operate in the conflict-affected state and so suffer most from its impacts. He cites a number of advantages in engaging local private sector organisations. First, they tend to be more labour-intensive than large firms and maintain more linkages with other local enterprises; second, they operate in different locations and therefore provide a stimulus for regional development; third, they are easier to deal with for national and local governments; and fourth, as the local private sector operates less internationally, local organisations are more likely to invest and expand locally.

However, it is clear that local companies are often caught up in the dynamics of a conflict, as demonstrated by the situation that has existed in Afghanistan. Giustozzi's (2006) study of the private sector there identifies that in many cases companies turn to the local 'mafias' and warlords as a way of getting things done in a context where 'official' authorities are seen as too weak, incompetent, or corrupt to provide useful service. As a result, relationships between business people and mafia 'have evolved into forces that reduce opportunities for longer term growth and a more rounded social role for business' (226).

2.1.4 The role of donor-led PSD and other programming

Given these different motivations and impacts, how should donors react? Focusing on those elements of the private sector for which peace and security are commercially beneficial is crucial. As has been noted elsewhere, some companies benefit from conflict and thus it is important for PSD and other development professionals to be aware of the dynamics of the private sector in this regard. A key challenge is being able to attract and encourage companies given the significant risks involved. As Peschka (2011:8) observed, 'in the absence of basic security ... businesses are reluctant to make the long-term investments that spur economic growth and generate the jobs so desperately needed in these challenging contexts'.

Regulatory reform

At the most basic level, companies want to be sure that their investment in a country is secure and that, at the very least, they will be able to recoup that investment. Evidence

suggests that developing economies with better business regulations achieve faster annual economic growth rates. For example, according to Samuels (2006:12), 'rule of law is essential to economic development and poor enforcement of business contracts is damaging for countries rebuilding from conflict'.

Appel and Loyle (2012:689) argue also that putting in place processes of post-conflict justice (such as truth and reconciliation commissions) allows states to 'send a costly and credible signal to international investors about the state's willingness to pursue the successful reconstruction of the post-conflict zone'. In their view, establishing post-conflict justice structures, which is a hard thing to do, sends the message that the host government is serious about change and reform and as such 'can act as a signal to reduce investor risk'.

Blended finance as a tool to reduce risk

The literature also explores the degree to which new 'blended finance' approaches to development might help address the issue of perceived and actual risk in FCS. Cusack and Tilleard (2013), for example, point to the potential for sovereign wealth funds (SWFs) to act as a process for providing investment and encouraging other private sector entities. The same point is made by Torjesen (2013), specifically in relation to the Norwegian sovereign wealth fund Norfund. Her analysis is that investment in post-conflict countries is often concentrated into a few sectors and often only appears several years after the conflict has come to an end. Norfund, she argues (and, by extension, other SWFs), is in a position to be able to provide funding more immediately after a conflict has come to an end, and to stimulate investment in a wider range of sectors and therefore spread risk in the economy.

Ideally, entities such as the IFC should play a coordinating function, as in a project to develop local supply chains. The IFC (and indeed the World Bank and United Nations agencies) has political credibility and convening power, and therefore is well placed to bring different partners together and to find joined-up ways of dealing with at least some of the challenges companies face in operating in FCS. Cusack and Tilleard (2013) make a strong case for international development actors to facilitate private sector investment in FCS, for example by acting as co-financer or as a shared hub of knowledge on which a number of companies can draw.

Building capacity

The ability of governments in fragile states to operate effectively is crucial. Focusing specifically on the issue of natural resource management in Africa, Besada (2013:2) argues for the 'critical importance of governance – the deficiency or effectiveness of public and private sector institutions – as the key to understanding the prevalence or absence of violent conflict'. He cites the example of Debswana, a joint venture between the Government of Botswana and the mining firm De Beers. This firm is key to the diamond sector, which accounts for about half the country's tax revenues. As part of a strategy to diversify the economy, Debswana has also made investments in tourism, farming, and education, thereby using 'diamond revenue for economic development objectives, infrastructure development and poverty alleviation programmes' (Besada, 2013:39).

Frequently, however, a challenge facing the private sector in fragile states is a lack of capacity in the governmental structures of those states. Whatever the regulatory framework may be, in many cases the structures through which those regulations are implemented lack capability and capacity. Civil servants are sometimes unaware of their proper role and lack

the necessary skills to do the job for which they are in principle employed. Alternatively, there may simply be a lack of properly qualified people. In Rwanda, for example, the effects of the Genocide are still being faced in that those people who might now have been middle- to senior-ranking civil servants are absent because they were killed in 1994.

Public–private dialogue (PPD)

A further challenge lies in developing relationships between the public and private sectors. Nelson (2014) argues that in fragile states and post-conflict economies, there is often deep mistrust between the government and the private sector, resulting from prevalent rent-seeking behaviours, cronyism, and lack of legitimacy. To overcome the lack of transparency and to create trust and confidence, it is imperative to engage the private sector in policy reform dialogue. Her work identifies a number of examples of good practice. For example, the Myanmar Centre for Responsible Business (MCRB) was established in 2013 to promote responsible foreign and domestic investment and business activities, with support from six donor governments, the Institute for Business and Human Rights, and the Danish Institute for Human Rights. MCRB works with government ministries, the Myanmar Investment Council, the Union of Myanmar Federation of Chambers of Commerce and Industry, foreign embassies, and various foreign investors like Total, Coca-Cola, Western Union, and Chevron.

Utterwulghé (2014) argues the same case that PPD mechanisms have demonstrated ‘that they are effective trust-enabling platforms that allow all relevant stakeholders to work jointly in a transparent way on the identification of PSD constraints and the creation of sustainable policy reform solutions’(25). As Lemmon (2012:15), looking at business development in fragile states, concluded: ‘Partnerships among governments, non-profits, and corporations are critical. Long time frames are also important because sustainable SME growth is a long-term process that requires capacity building and the development of local business environments. There should also be greater information sharing of lessons learned and efforts to scale solutions that have been successful’.

Firm-level interventions

It is also apparent that firm-level interventions are highly relevant. Based on GIZ’s experiences in the Palestinian Territories and Yemen, Schrade *et al.* (2016:22) argue that PSD has a role to play even in situations of hot conflict, providing benefits both in terms of economic development and peacebuilding. Indeed, in their view, ‘PSD has a huge comparative advantage to other development sectors (e.g. education, rule of law, or good governance) when it comes to contexts of open and sustained violence’.

A special issue of the *Journal of Conflict Resolution* (57/1) looks in detail at both the need and type of support required by entrepreneurs in conflict-affected and post-conflict states. This set of articles identifies three sets of policy implications. First, given the varied impacts of conflict, there is a need for support to be geographically specific. Second, given the need for companies to adjust to the realities of conflict, PSD policies that support companies in being adaptive so that they survive the conflict are vital. Third, because companies provide a means for economic growth and post-conflict employment (for example of ex-combatants), support to the private sector as a key part of peace deals can be an important element in making sure that those accords actually endure.

2.1.5 Approaching PSD in FCS

As well as commenting on the types of intervention that are most useful in FCS, the literature also looks to a significant degree at how those interventions need to be structured, as well as what different factors need to inform the way in which PSD and other programming needs to be managed and undertaken.

Monitoring and evaluation

A key difference in undertaking PSD activities in an FCS context by comparison with a 'normal' location is the need to focus on different – or, rather, additional – metrics. In most PSD programming, 'success' will usually equate to factors such as increases in the number of jobs or growth in levels of income. However, looking only at economic data in FCS is not sufficient, as 'success' on an economic level might come at the expense of worsening the conflict dynamics. In a study of privatisation in post-conflict countries, Venugopal (2014:1) concludes that the success of such programmes is generally seen through an economic prism, 'such as the dollar value of privatisation receipts, increases in firm-level output, or productivity'. In his view, however, the reality is that this approach actually causes much greater problems in peacebuilding terms by entrenching inequities in society and thereby aggravating conflict dynamics.

Indeed, Schrade *et al.* (2006:14) argue that there is a need to go further. As well as ensuring that interventions are based on proper peace and conflict assessments, as well as designed according to the 'Do No Harm' principles, there is also a need to monitor potential risks in real time. In regard to its operations in the Palestinian Territories and Yemen, GIZ has developed a 'risk log system [that] allows close monitoring and immediate action if a specific activity proves to drive conflict or violence'.

Balancing urgency and legitimacy

A further issue highlighted in the literature is the tension, especially in post-conflict situations, between getting things done swiftly and getting them done in a way that builds legitimacy and buy-in from local audiences. As Channell (2010:5) argues, 'donor organisations often rush to re-establish the framework for doing business, from rebuilding roads and marketplaces to revising laws and regulations'. The challenge with this, he argues, is that laws developed in such a way are not seen as legitimate – 'effective policy reform ... takes time in order to negotiate the human dynamics'. In his view, the key to this is the existence of a strong voice for the private sector, as 'the business community knows better than any other group what constraints are standing in the way of business'.

Jones and Howarth (2012) argue that short-term programming, however well intentioned, can be damaging to longer-term sustainability. Looking specifically at infrastructure projects, they criticise the 'Quick Impact Project' approach undertaken in Iraq and Afghanistan since 'the approaches necessary to carry out implementation (for instance through construction undertaken by the military) may undermine the scope for local ownership through community consultation and participation'.

2.2 The challenges facing middle-income countries

In the past decade, the challenges facing middle-income countries in continuing their progress from poverty have been widely explored. The term 'middle-income trap' seems first

to have been used to describe apparent growth slowdowns in many former East Asian 'miracle' economies (Gill and Kharas, 2007). A variation on the term had also been used in 2006 about the sustainability of China's economic development (Pei, 2006). Since then, the phenomenon by which countries rapidly acquire middle-income status only to stall at that point has been observed by several studies. Robertson and Le (2013:7) conclude from their analysis that 'the growth trajectories of a large number of current middle-income countries are consistent with what we would expect to observe if they were in a middle-income trap'.

2.2.1 Inclusive growth

Supporting countries in continuing their progress from poverty is not simply about economic growth *per se* but also about ensuring that this growth benefits as wide a proportion of a country's population as possible. This issue of inclusive growth is particularly pertinent to a study that focuses on the private sector given the considerable debate about whether companies promote pro-poor development or instead worsen inequalities. A recent statement by the EU (2014) argued that the 'private sector can be an engine of inclusive growth by generating decent jobs, contributing to public revenue and providing affordable goods and services'. Likewise, according to an article by a senior Asian Development Bank (ADB) official (Venkatachalam, 2014), 'the private sector promotes not just growth — it promotes inclusive growth'. A review of China's development concluded that the private sector not only contributed to economic growth but also 'helped the country to cope with the societal impacts of the decline in state industry' (Hasan *et al.*, 2009).

However, other evidence suggests that the private sector can fail to foster inclusive growth. CAFOD (2011:8), for example, concluded that 'oil, gas and mining operations may bring considerable FDI but create relatively few local jobs'. Other studies also suggest that while FDI can be beneficial to overall GDP numbers, it does not necessarily create broader-based growth, which depends on a number of variables. These include, for example, the strategies of the investing companies and the extent to which they are prepared to share knowledge and expertise with domestic firms (Spencer, 2008). The ability of local firms to absorb the technologies and practices presented by foreign companies is also important. Foreign investment therefore has greater developmental impacts when domestic firms are larger and the technological gap between them and incoming companies is smaller (Zhang *et al.*, 2010).

2.2.2 Key challenges in addressing the middle-income trap

What causes this stalling in progression from poverty? Studies by the International Monetary Fund (IMF) (Aiyar *et al.*, 2013), World Bank (Dinh, 2013), ADB (Felipe *et al.*,) and the Organisation for Economic Co-operation and Development (OECD) (Jankowska, 2012) have all sought to understand which factors assist a successful transition and which hinder it. Drawing on all these studies, the key factors are as follows:

- **Stability:** This is seen as a *sine qua non* of continued development. Countries that are affected by war, conflict, or natural disasters will face significant challenges in maintaining stable development.
- **Political institutions and transparency:** The institutional underpinnings of politics and the economy are of key importance. Four areas in particular are highlighted: size of government, rule of law, freedom to trade internationally, and the presence of effective regulation.

- **Structured development:** Whether by government edict or through government allowing the private sector space, countries succeed where there is a structured but realistic approach to development.
- **Economic management:** Capital inflows are valuable, but macroeconomic stability is key, and public debt needs to be managed. Likewise, countries that rely too heavily on resource exports are also unstable.
- **Industrial diversification:** Countries that have graduated most swiftly and successfully from lower-middle to upper-middle and then to high-income status have been those which had a greater diversity and sophistication of exports.
- **Internal and external resources and infrastructure:** Inside a country, power, roads, and other infrastructure are essential, while a bulge in the working age ratio is also seen as an asset. External links are also important to success; for example, proximity to trade partners makes business more straightforward.

2.3 Issues for this study

This review of existing literature on FCS and middle-income states has identified a number of issues that this study will explore in more detail. These include the following:

2.3.1 Regional issues

It is clear from the literature on both middle-income countries and FCS that inter-country regional dynamics are a key factor, particularly in relation to commercial and private sector links. For example, middle-income countries are more likely to remain on their positive trajectory if they are located close to trading partners, while FCSs' border disputes are more likely to be non-conflictual where there are mutual trade and commercial linkages. Additionally, given that many conflicts are regional in nature or have regional impacts, the international dimension is one that needs to be examined.

2.3.2 Country context

As noted above, stability is seen as virtually a *sine qua non* if a country wants to progress beyond middle-income status. The presence of conflict or tension is therefore a crucial challenge. A central issue for this study to address will be how PSD and related interventions can be used to create and support stability. It is likely that this will need to consider both short- and longer-term activities depending on the stage and nature of conflict, and for these activities to be effectively joined up. However, this will be complicated by the fact that the situation may vary considerably in different parts of a country, reflecting the fact that a conflict or conflicts may be geographically limited.

2.3.3 The private sector

The structure of the private sector and the constraints to its development – at all levels from firm level to the regulatory environment – are key to the capability of states to maintain and develop from middle-income status. However, it is clear from the literature review that not all segments of the private sector will necessarily be supportive of peacebuilding. Some elements may benefit from conflict (for a range of reasons) and there needs to be a clear assessment made of this. The literature stresses the need for robust conflict analysis when operating in FCS. However, in the case of PSD interventions, conflict analysis needs also to

extend to an examination of how different elements of the private sector might be factors in the conflict.

The obverse of the above is to understand what structure for the private sector would be most beneficial to the stable development of the host country, and what challenges there might be to the development of that ideal. It is highly likely that the obstacles will be different for different aspects of the private sector. Foreign investors might be put off by perceived risk, whereas local firms might suffer from poor capacity or be hindered by elite capture of key elements of the economy. This study needs to explore what form of analytical framework would best serve to understand these issues properly.

2.3.4 Tasks and roles in PSD

It is clear from the literature that the issues impacting on the private sector are derivative of wider institutional and political challenges in a country. PSD programming therefore needs to be closely aligned with other streams of donor activity. This is not just to ensure an improved environment for the private sector but also to ensure that PSD programming is proactively supporting and buttressing wider conflict-management goals.

It is also clear that PSD programming needs to encompass all aspects of a country's private sector, which will range from foreign investors to large national firms, through to SMEs and other local firms. As the literature demonstrates, facilitating the private sector's ability to diagnose the issues it faces through developing PPD platforms is of significant importance. However, it is important to maintain ongoing relationships and to engage companies (for example, foreign investors) that may not be present at the start.

The literature also identifies a key role for blended finance mechanisms to reduce risk in FCS. Given that more donor governments are putting increasing amounts of money into vehicles such as the Private Infrastructure Development Group (PIDG), the CDC (formerly the Commonwealth Development Commission), and the Dutch Good Growth Fund, it is important to look in more detail at how this may best be achieved.

What is less clear, however, is where PSD programming should best focus. Given that many of the challenges companies face stem significantly from macro-level institutional issues, it may be most relevant for PSD to focus here. However, much of the literature points to the role of company- and market system-level interventions to provide the private sector with resilience and capacity at different phases of the conflict cycle. The current study will therefore have to establish the appropriate balance between macro-level interventions and those at a more local level, with different elements of the private sector and at different phases of the conflict cycle.

3 Regional context

The literature strongly suggests that regional dynamics are important both in terms of a country's ability to thrive economically and in relation to its conflict dynamics. Proximity to trade partners makes business more straightforward. Countries that are better positioned geographically – close to suppliers and customers, and on good trade routes – generally perform better than those which lack these advantages. As an IMF report observed, 'the greater the GDP-weighted distance of a country from potential trade partners, the higher the probability of an economic slowdown. And the greater the share of intra-regional trade undertaken by a country, the less likelihood there is of an economic slowdown' (Aiyar *et al.*, 2013:26). In the area of conflict and instability too, it is clear that regional factors play a key role. Miall *et al.* (2004) propose a framework for understanding the sources of conflict, which suggests that there are different levels at which causation of conflict occurs. They propose a 'levels of analysis'³ approach. In their view, conflict needs to be seen as caused by both international and domestic factors, which they refer to as International Social Conflict. These they define as 'conflicts that are neither pure international (interstate) conflicts, nor pure social (domestic) conflicts, but sprawl somewhere between the two'.

3.1 Economic and conflict impacts, and their inter-relation

It is clear from the literature, and reinforced by the fieldwork for this study, that not only is it regional factors which have significant impacts on countries' economy and conflict dynamics but also that these factors inter-relate to a considerable degree.

Several of our focus countries have seen markets and trade seriously limited by instability and tension in neighbouring countries. In the case of Sudan, relations with key neighbours Egypt, South Sudan, and Eritrea are extremely tense. Ethiopia has until very recently had an ongoing frozen conflict with Eritrea, which historically provided Red Sea access. Regional trade can also be limited where a country sits adjacent to a regional economic community and thus does not have the same advantages as other neighbours. For example, Ethiopia sits adjacent to the East African Community, which facilitates economic activity between Kenya, Uganda, Tanzania, Rwanda, and Burundi. Lebanon and Egypt have both seen regional markets disappear or become inaccessible because of conflicts in their region. This is most strikingly illustrated by the impacts of the Syrian civil war: for both countries, Syria was both an important end market and a transit route to the countries of the Arabian Gulf.

Ethiopia's landlocked status is a key determinant of its political and trading relations with neighbours. With until recently a longstanding frozen conflict since Eritrean independence, Ethiopia lost its access to the sea as well as potential for cross-border trade with Eritrea. In response, it has forged links with Djibouti, Somaliland, and more recently Sudan to secure port access and facilitate trade. For Sudan, tense relations with neighbours limit cross-border economic activity, including with Egypt and South Sudan. For both countries, communities in significant areas of the borderlands are pastoralist and share cultural and economic ties across borders; however, these are often marginalised communities in areas with little formal private sector activity.

Non-economic factors also have significant bearing on regional economic relationships. These factors include religious alignment (including an inclination toward forging a national

³ In this they draw on Levy's chapter 'Contending Theories of International Conflict: A Levels of Analysis Approach' in Crocker and Hampson (1996).

Islamic identity in the case of Sudan) and linguistic ties (across the Arab world, for example). Also of relevance are a shared opposition to Islamist terrorism, desire to counter other powerful nations, and sometimes a shared opposition to 'western' interference. The last of these is illustrated by the case of Sudan being supported by others opposed to the International Criminal Court and other restrictive international frameworks, including Kenya and other African Union members as well as Russia). In several of our case study countries, shifting political allegiances and economic ties align. For example, Sudan has experienced shifting allegiances within the Arab world, often falling into a different power bloc to its immediate neighbour Egypt. Tensions within the Gulf Cooperation Council and Sudan's refusal to sever ties with Qatar when it was accused by its neighbours of sponsoring terrorism are an example of this. More recently, growing ties between Sudan and Turkey appear to have both trade and strategic intentions, with suspicions that Turkey may establish a military base on Sudanese territory (much opposed by Sudan's neighbours) as well as becoming a key investor. At the same time, a softening of global relations with Sudan, lifting of sanctions, increasing focus on macroeconomic reform, and potential business linkages have been linked by some to a desire by western donors to forge stronger relationships with potential security partners as allies in countering extremism. Relations between Ethiopia and key western donors have the desire for stability and security in a broadly unstable region as a key driver. Power blocs, then, are more complex and overlapping than during the cold war, with alliances forged on religious and cultural grounds as well as security imperatives and the potential for proxy wars in the case of Sudan and Egypt/Eritrea within the broader region.

Moreover, the policy and aims of neighbours can be highly influential on a country's potential. For example, Nepal's most important strategic relationship is with India, with which it shares a 1,000-mile open border and strong historic, linguistic, religious, economic, and cultural ties. Nevertheless, political issues and border disputes strain this relationship. Nepal's heavy reliance on Indian exports (fuel, for example) and on access to Indian ports has led to the country being described as 'India-locked' rather than simply landlocked. Some anti-Indian sentiment in the country is linked to perceptions of Indian meddling in Nepalese political affairs, most recently in regard to India's effective five-month economic blockade of Nepal, which was linked to Nepal's constitutional crisis in 2015. On the other side, the relationship with China has historically been much weaker, with the Himalayas acting as a major physical barrier. However, in 2017 Nepal joined China's 'One Belt, One Road' initiative (allegedly against Indian lobbying for Nepal to stay out). Investment in infrastructure will lead to much greater connectivity in transit, roads, railways, trade, aviation, and power. The competing economic and strategic interests of China and India offer opportunities for Nepal; however, sovereignty concerns (potentially stoked by a protectionist domestic private sector) deter Nepal from fully benefitting from this strategic competition between its neighbours, undermining the potential for foreign investment in key economic sectors.

Myanmar sits at the heart of Asia, bordered to the northwest by the nations of India and Bangladesh, to the southeast by Thailand and Laos, and by the People's Republic of China to the northeast. Myanmar's neighbours, particularly China, are the country's chief export markets and the source of inward investment. China, India, and Thailand, along with South Korea and Malaysia, compete to invest in oil and gas extraction. China is also investing in infrastructure, such as taking a majority stake in the major new deep-sea port of Kyauk Pyu in Rakhine State, as well as investing in a special economic zone located at the port. These developments will secure China's access to the Bay of Bengal and could represent the first step in a new China–Myanmar Economic Corridor connecting Kyaukpyu and Kunming in

China,⁴ although deals such as these are frequently criticised for limited economic benefits within Myanmar itself.⁵ At the same time as contributing to development, infrastructure and resource exploitation have been at the root of ongoing conflicts between the central government and ethnic minorities located mostly in Myanmar's border areas.

The literature argues that geographic linkages are strengthened and underpinned by 'social proximity links' between people who collaborate over time. Innovation and growth does not just occur because companies and their people are physically close together, but because they get along and want to work together. As Lorenzen and Mudambi (2012:506) make clear, 'decentralized personal relationships have remained the dominant linkage type in value creation... Value is created through flexible linkages between persons rather than rigid linkages between organizations'. However, in situations where conflict and instability has disrupted these 'social' links it may be that the economic effects of a conflict situation persist even after a conflict has ended since these networks may take time to re-emerge. If prosperity comes to a degree from the interactions of individuals and companies, then disruption of these will be detrimental from an economic and business perspective.

That said, it appears that in many cases diasporas provide a very valuable vehicle for maintaining these networks, contributing to economic growth even while instability persists. In the case of Lebanon, it is estimated that there are several times as many people around the world calling themselves Lebanese than the population of the actual country. Lebanese-run businesses operate all over the world and provide a well-established network for commercial activity. In Ethiopia, diaspora return and investment has been a key feature in recent years. Some suggest that there is a tendency toward diaspora investment in real estate due to instability and fragility but also weak protections. Nevertheless, the creativity in diaspora-led business is evident in urban centres with businesses building on knowledge gained elsewhere, such as tech-based start-ups and design-based industries such as fashion and accessories. Furthermore, in Sudan it is evident that businesses adapt and expand based on extensive personal networks, including international networks, with big businesses forging partnerships internationally in order to gain new technical expertise and access to markets. The fact that the elite have travelled, lived, and studied internationally for several generations supports this.

3.2 The importance of infrastructure

From the perspective of trade and conflict, connective features such as dams, watercourses, resources, roads, and other infrastructure are extremely important. They can either be sources of opportunity and potential prosperity or they can be the focus of tension. It is extremely important therefore to consider infrastructure from a regional rather than just a national perspective. Building and supporting infrastructure that facilitates economic cooperation across borders is critical to long-lasting peace and stability. In the case of Ethiopia, which is dependent on neighbours for sea access, roads, railways, and port facilities are crucial. Recent initiatives have sought to improve cold storage along the main transit route to Djibouti while agreements to share port facilities are being forged with Somaliland and Sudan (which would require improved transport between Addis and Port

⁴ Aung San Suu Kyi and President Xi Jinping agreed to establish such a corridor during a meeting in Beijing in December 2017: see <https://amti.csis.org/kyaukpyu-china-indian-ocean/> (accessed 15 June 2018).

⁵ Popular criticisms, for example, relate to the export of gas to Thailand while Myanmar is facing energy shortages. In addition, Khandelwai *et al.* (2018) found few direct economic spillovers from the special export zone at Thilawa near Yangon.

Sudan). At the same time, infrastructure in some border areas, such as along the border with Kenya or South Sudan, is negligible, which limits even very localised economic activity across borders. Roads, water points, markets, and storage facilities could all facilitate cross-border market activity.

Egypt and Sudan are potentially hugely affected by the policies of those further upstream in the Nile basin, with significant changes expected due to the Grand Ethiopian Renaissance Dam (GERD). In the case of Egypt, there is a fear that short-term reduction in Nile waters will negatively impact agricultural production and there has been a sharp deterioration in relations between Egypt and Ethiopia as a result. Sudan, in contrast, stands to benefit from a better regulated Nile flow and has less to lose in the short term due to current under-utilisation of Sudan's Nile waters. Sudan's apparent support for GERD has, however, increased tensions between Egypt and Sudan. More broadly, Egypt, Sudan, and Ethiopia are potentially impacted by other states within the Nile Basin Initiative, which exists in recognition of the interdependency of states in the Nile basin (including the Great Lakes) and seeks consensus and cooperation.

In both Nepal and Myanmar, large-scale investments in infrastructure in ethnically controlled or marginalised areas also fuel tensions. The recent influx of foreign investment and the development of infrastructure and special export zones have exacerbated conflict in Myanmar.⁶ Ethnic armed organisations reject central government land and resource allocation to investors in the areas they control. In Nepal, while infrastructure (much of which was destroyed in the civil conflict) is badly needed for economic development, there are persistent tensions over community rights. Exploitation of hydropower has stoked conflict between communities and hydropower developers supported by the government, such as the violence at the Khimti Dhalkebar plant in April and July 2016.

3.3 Fear as well as reality

Fear of the regional context influences popular opinion and political actions every bit as much as the reality of the situation. This fear may be stoked and manipulated in support of domestic political objectives. For example, in Egypt the fear of 'becoming like Syria or Iraq' is a powerful driver to current political dynamics and some degree of toleration of the policies of President Sisi. In Sudan, tensions with Egypt, Eritrea, and regional powers in the Middle East foster a nationalistic tendency and bolster an inclination to maintain the political *status quo*, while in Ethiopia the mantra that the country is an island of stability in a fragile region (and the need to maintain this) has detracted attention from internal instability.

The legacy of previous conflict and instability is also of key importance in framing people's outlook. The conflicts in Myanmar are related to control of territory, authority over populations, and access to resources in the regions bordering China and Thailand, which have experienced persistent and widespread conflict for over 50 years. Central to the conflicts are contested visions of what constitutes the nation. In Nepal, historically marginalised groups – many of whom supported the Maoists in the civil conflict – are pressing for a greater voice in politics, a greater share of economic benefits, and a recognition of their cultural identity. While cross-border issues, including blockades,

⁶ 5.2 million acres of land have been given to investors for large-sale agriculture concessions (Asia Foundation, 2017).

investment, and smuggling, have fanned the flames in these countries, these are decidedly local affairs.

3.4 Concluding remarks

The evidence from this study demonstrates how significant can be the impact on a country of its regional context. Therefore, it is important for those seeking to support countries in building peace and economic growth to understand that context, as well as the impact it has domestically.

A starting point is to understand the various ways in which a country may be affected by regional factors. This will include understanding the direct economic impacts of conflicts or tensions in neighbouring countries: Lebanon and Egypt, for example, have lost the significant Syria market and access to the Gulf States. Also important are the impacts of regional conflicts on a country's physical security. Lebanon, for example, has been destabilised by the Syrian situation, while Egypt has the risk of instability caused by the Libyan civil war.

Regional debates and squabbles can also have significant impacts on a country's economic potential. Nepal, for example, will always be subject to the effects of decisions taken by India. Similarly, debates and discussions in regional forums will affect an individual country's scope for movement. Tensions within the Gulf Cooperation Council and Sudan's refusal to sever ties with Qatar when it was accused by its neighbours of sponsoring terrorism are an example of this. Crucially, whether and how key elements of infrastructure might affect a country are highly significant. Understanding these dynamics and proactively managing them or at least mitigating the risks is a key task of those in the development community.

However, it is not just the direct impacts of regional instability that can have a domestic impact on a country: the perception and fear of instability can also be highly significant. Countries such as Egypt and Lebanon have seen their neighbours descend into crisis and civil war, and the desire to avoid the same fate is a very powerful driver in domestic politics. Also important are historical memories and grievances: history is still very much alive. These factors need to be understood and their significance appreciated since these 'psychological' impacts are highly pertinent.

Regional issues are therefore fundamental to the ability to understand a country's domestic context. These results may be direct, in terms of lost markets, for example, or indirect, in terms of the impacts on domestic opinion. In all cases, these factors need to be taken into account.

4 National context

The previous chapter explored the regional factors impacting on the ability of a country to progress toward peace and prosperity. This chapter now looks at the challenges posed by the internal dynamics of the country itself. What domestic factors affect a country's ability to maintain or attain stability, and to move on past middle-income status, and what can the international community do to help?

4.1 Shifting dynamics of conflict and fragility

Fragile middle-income countries face a shifting set of dynamics of conflict and fragility. Some processes of transition can be seen as a linear process in which steps and developments can be straightforwardly managed and planned. Addressing conflict and fragility is more complex, because the nature and intensity of these issues is in flux over time. In managing these issues, countries and their international backers are chasing a moving target.

Moreover, there may be more than one source of instability that a country needs to address. All the countries reviewed for this study were selected because they were listed in DFID's FCS analysis. However, what became apparent in relation to several of the countries is that the conflict or tension currently catching the headlines, and seen as the reason for that location's inclusion in an FCS list, was not actually the main issue for concern. A good case in point is Lebanon, where the focus is on the huge Syrian refugee influx with which the country has had to cope over the past few years. According to the United Nations Refugee Agency (UNHCR), in June 2018 there were around 1 million Syrian refugees in Lebanon.⁷ This is by contrast to an existing population of around 6 million. This huge number of refugees in such a relatively small country has been seen as a significant source of potential fragility and a huge humanitarian relief effort has been mobilised. The UNHCR is campaigning to raise more than \$2 billion to address the refugee crisis. However, serious though this issue is, Lebanon is dealing remarkably well with the refugees. The dynamic that would be more dangerous if it went awry would be the delicate balance between the different confessional groups.⁸

For most investors and policymakers outside Myanmar, the intercommunal violence between Rohingya Muslims and the Buddhist population in Rakhine State represents the key source of fragility and violence (Asia Foundation, 2017). The eruption of violence in August 2017, and the 900,000 refugees from Rakhine now in Bangladesh, have been the focus of much attention.⁹ However, despite the scale and severity of the violence in Rakhine, it is not the only live conflict in Myanmar, nor the one with the most widespread consequences. Conflicts between the military and ethnic armed organisations (EAOs) have been ongoing at least since Myanmar's independence from the British in 1948, mostly concentrated in the regions bordering China and Thailand, which had a history of self-governance from before and during colonial rule. At least 21 EAOs are involved in conflicts related to the control of territory, authority over populations, and access to resources, although the fighting has generally been of low intensity in recent years (Asia Foundation, 2017; Burke *et al.*, 2017) and ceasefires have been signed with a number of EAOs including the Chin National Front, the Karen National Union and the Pa-Oh National Liberation Organisation. Other ceasefires

⁷ See <http://data2.unhcr.org/en/situations/syria> (accessed 16 June 2018).

⁸ The Lebanese polity is divided into 18 'confessions', which are ethno-religious groupings. The largest three are Christians, Shia Muslims, and Sunni Muslims.

⁹ See http://data2.unhcr.org/en/situations/myanmar_refugees (accessed 16 June 2018).

have broken down, however, such as that with the Kachin Independence Army. In 2015 and 2016, there were 1,022 clashes between the government and EAOs, mostly in Kachin and northern Shan state (Asia Foundation, 2017).

4.2 Elite control: on whose behalf is government run?

A factor that defines most of the countries reviewed for this study is that political control and patronage is held in the hands of a relatively small elite, who use government power and preferment to further their own interests, not necessarily those of the wider public. From the perspective of pro-poor development this is self-evidently a challenge, as government policies cannot be relied upon to focus on the needs of the poor but rather toward those of elite groups and their networks (as illustrated by Egypt, Nepal, and Sudan).

In Egypt, the government is run by, and largely acts in the interests of, the military. President Sisi's power base lies in the army – he is a former Field Marshal – and many of those interviewed observed that, even beyond the president, many of the key figures in government are from the military. The influence of the military thus spreads into all aspects of the country's life. The Alexandria desert road was built by the army, and the military own businesses in many different sectors. Although nominally a democracy, the electoral process in Egypt is highly flawed. In the recent presidential election, the incumbent, Abdel Fattah el-Sisi, used a mixture of tactics to exclude many rival candidates from standing. In the months before the election, all major, credible alternative candidates were removed, including Sami Anan, former Chief of Staff of the Egyptian armed forces, Colonel Ahmed Konsowa, and Ahmed Shafik, a former commander-in-chief of the Egyptian air force. In the election itself, only one candidate stood against Sisi, Moussa Mostafa Moussa, who was widely seen as a stooge. As one press report put it, Moussa had 'endorsed Sisi for a second term and even organised events to help nominate the former military commander up until a week before the nomination deadline' (Ibrahim, 2018). At the election itself, Sisi won more than 97% of the vote, albeit on a relatively low turnout of 41%. This centralised control is accompanied by the serious abuse of many human rights. Human Rights Watch accuse Sisi of overseeing the 'worst human rights crisis in decades', in which 'police systematically used torture, arbitrary arrests, and enforced disappearances to silence political dissent. Thousands of civilians were tried by military courts. By introducing new restrictive NGO legislation, detaining journalists, and prosecuting human rights defenders and subjecting them to travel bans, the government is working to eradicate independent civil society in the country.'¹⁰

If the situation in Egypt is one in which a single military elite control the country, Lebanon has a situation in which a series of elites control that political and governmental process. Lebanon is home to a multiplicity of different groupings based on a mixture of religion and politics. As was touched on above, there are 18 so-called 'confessions', which are based on the make-up of the country in the 1932 census. Seats in parliament are allocated according to these confessional groups, and the senior positions in government are allocated to the three largest groupings: the president will always be a Maronite Christian; the Speaker of the Parliament, a Shi'a Muslim; and the Prime Minister, a Sunni Muslim. As a result of this approach, political debates are not on the basis of ideology or of a coherent policy platform but rather on the basis of confessional bias. This system is a recipe for inertia. The 2018 election was the first to happen in nine years, parliamentarians having extended their term three times since the last elections in 2009. Making any meaningful change happen is a

¹⁰ See www.hrw.org/middle-east/n-africa/egypt (accessed 14 June 2018).

considerable challenge as this requires securing the support of different confessional groups and of the vested interests to which they owe fealty.

Nepal's political settlement is based on exclusionary patronage, rent-seeking, and corrupt relations between economic and political elites, which weaken the country's economic prospects. This system is largely well understood and accepted by all key stakeholders, making it stable and difficult to dislodge. The Maoist insurgency in Nepal and the armed conflict that emerged from it was fuelled by this political and economic exclusion. The Maoists were able to garner support from groups who felt left behind, particularly lower caste, regional, and ethnic groups. They were therefore able to gain significant sway over the countryside by the end of a war that destroyed infrastructure, disrupted production and trade, weakened private sector investment and led to firm closures, expended limited resources (e.g. on arms and military spending), and distracted the government from economic issues.¹¹ Since the end of the 'people's war' in 2006, Nepal has been engaged in a protracted political transition toward federalism as a response to the grievances that contributed to conflict. The idea behind this is to give ethnic, caste, or regional groups such as the Madhesi in the Terai region a greater voice in politics and a greater share of economic benefits.

Sudan's party system, too, is dominated by one party, the National Congress Party, a creation of the ruling military-backed government to build a popular support base. Major opposition parties boycotted 'democratic' elections in 2010 and 2015, with the result that the outcomes were not universally recognised. Use of force to suppress popular demonstrations against tightening austerity and cuts to government subsidies in 2013 left little confidence in, or enthusiasm for, the elections of 2015. Autocratic and repressive behaviour by Bashir's government has increased while key figures within the military and security forces are believed to have substantial control over politicians, including cabinet members. Civil society, the media, and international NGOs are closely watched and targeted. Harassment of opposition politicians and the press has increased, and the government has continued to use force in Darfur, the Blue Nile, and the Nuba Mountains.

4.3 Challenges in government capability and capacity

The challenges presented by elite control are compounded by the fact that the civil services in many countries are inefficient. This makes effecting change – and, more importantly, making sure it sticks – harder.

In Ethiopia, there are administrative structures at various levels throughout most of the country, alongside a strong network of security structures, and these enforce laws, collect taxes, and bear responsibility for provisions of social services such as health, transportation, water, electricity, etc. However, the strength of these institutions declines with distance from Addis Ababa. While security provision is strong, other services are either weak or seen as mechanisms of government control. Protests in Oromia and Amhara against government institutions such as prisons, service centres and office buildings, health facilities, and cooperatives reflect a perception that these places exist to control the population more than to perform their purported functions.

¹¹ Growth in the 10 years before the war averaged 4.9%, versus 4.0% during the war and 4.1% in the period since the war (UNCTAD, 2011).

In Egypt, it was widely reported by interviewees that nepotism is widespread in government appointments. Families make use of their contacts and *wasta* (influence) to get their children jobs in government. Such jobs are seen as being very desirable and prestigious by contrast to jobs in the private sector. The result is a public sector that is both bloated in numbers and ineffective in its delivery. Officials are in place because of their connections, not their capabilities. However, the pressure to reform the public sector is apparently lacking. The regime itself finds it difficult to effect change through what are seen as cumbersome administrative bureaucracies. Therefore, tasks are given to the military to avoid logjams. For example, a project to build a road between Cairo and Alexandria was bogged down in government for many years until it was handed to the army to complete. While this approach has the advantage of making sure that things get done, it removes any pressure on government bureaucracies to change and improve over time.

In Myanmar, challenges arise due to rapid economic policy reform in the context of limited government policy capacity, leading to *ad hoc* decisions, while the limited technical capacity of bureaucrats at middle and low levels of government contributes to unpredictability. Under the military regime, lower-ranking officials were used to top-down instructions and there is consequently a lack of capacity or culture of autonomy. Minor issues are escalated, further delaying decision-making.

4.4 Political economy and fragility analysis

It is vital to understand what is actually going on in middle-income countries and FCS: viewing such places through the lens of international norms may not be helpful. The potential 'inappropriateness' of typical donor approaches is demonstrated in the case of the Central Bank in Myanmar. In 2013, the bank gained independence under the reformist president, Thein Sein, which was celebrated as a positive step by international investors. Some questioned how independent the Central Bank would really be as the incoming governor, Kyaw Kyaw Maung, had also held the post in the period from 1997 to 2007 when Central Bank decisions were manipulated by the government. However, the real problem has turned out to be the independence of the Bank and its governor, which have delayed reforms that are being promoted by the government, particularly the needed modernisation of the financial sector. Lack of access to capital due to these stalled reforms is a top business environment constraint in Myanmar. Some were hoping that once Aung San Suu Kyi took power she would remove him from office, given that he was appointed by her predecessor. However, that would have been a clear violation of the rule of law, which she is trying to uphold, so the governor has stayed.

In Egypt too, the situation is more nuanced than it might appear at first sight. President Sisi is widely presented internationally as a military strong man. Commenting on Sisi's 2011 visit to the UK, *The Guardian* newspaper referred to the Egyptian President as 'an autocrat' (Shenker, 2011). More recently, *Foreign Policy* magazine published an article stating that 'Sisi is getting pretty good...at being a dictator' (Cambanis, 2015). By contrast, many of those interviewed in Egypt argued that Sisi's approach was not only necessary but even a desirable one to keep the country secure in a highly unstable region. People point to the civil war in Syria, the ISIS insurgency in Iraq, and, slightly further afield, the situation in Libya. Many conclude that, even if Sisi's policies have some undesirable effects, these are relatively unimportant if the result is that Egypt is able to remain stable. In this context, the usual policy focus of the international community's emphasis on free and fair elections, human rights, and so on is problematic. A number of those interviewed commented

adversely on this agenda: ‘the last time we tried proper elections, we ended up with the Muslim Brotherhood’ was the observation of one person,¹² expressing succinctly the views of others.

Clearly, therefore, high-quality political economy and conflict analyses are essential. These need to be completely open and not in any way shaded by wishful thinking. Before they start work, development programmers need to understand how things really are, and how they are viewed by locals – not how they would like to see them.

4.5 How much change is desirable?

While it might appear that the political situations in the focal countries are problematic, careful consideration needs to be given to assessing how much change is actually desirable. No matter how problematic the *status quo* might be, alternatives may well be a lot worse. Moreover, policy proposals from the international community may be regarded as undesirable by key constituencies. In developing their policy recommendations, donors and other international actors need to consider some key questions. First, how likely is it that the political settlement or institutions that we would like to be achieved through our interventions will actually come about, or work in the way we intend it? Second, if it does not, by shaking the political tree might we actually end up with a situation that is, in reality, much more problematic than the *status quo*?

The situation in Lebanon is a case in point. The political settlement, based on the 18 ‘confessions’, leads to a situation where political consensus is hard to achieve and each political grouping plays to its confessional gallery. This situation is widely blamed for failure to make progress on key issues such as the improvement in energy supply. However, here again, any attempt to address the political torpor needs to consider the effects of disrupting what might alternatively be seen as a delicate political skein. One interviewee¹³ described the political situation in Lebanon as being like a sheet of fabric being pulled in different directions. However, rather than being a bad thing, the pull on that fabric keeps it taut and resilient: seeking to change the balance of power might result in the stresses on the political fabric altering, with the result that it will rip. In the case of Lebanon, this means that a country that has remained relatively stable despite the huge pressures on it may dissolve into civil war and anarchy. The implications of this for the country, the region, and for the wider global migration situation would be severe.

In Sudan, while the lifting of sanctions was never thought of as a panacea for severe economic challenges, the opportunity it presented for reform has been squandered, with the government waiting three months before instituting reforms that exposed an extremely fragile economy. The fallout from this has increased pressure on the president and pushed an estimated 1.6 million people into humanitarian need in the first half of 2018. A fuel crisis has led to fuel being sold on the black market instead of being used to support agriculture, increasing food insecurity in the medium-term. Even large companies are struggling to afford export costs. This indicates that governments transitioning from conflict and fragility need support to plan and sequence reforms, including analysing potential impacts. Where capacity is known to be weak, conversations around these issues prior to any significant change are essential.

¹² Interview, Cairo, March 2018.

¹³ Interview, Beirut, April 2018

A question often posed is how, if at all, FCS differ from 'normal' developing countries. It is perhaps this issue which points up, most sharply, the difference between them. In 'normal' places, experiments can be made in regard to how change might be brought about and, if an approach fails, then the downside is relatively minor. Given how finely balanced the situation in FCS is, if a change agenda goes wrong then the downside is not merely a poor annual review on the donor programmes involved – it is the possible re-emergence of war and conflict.

5 The private sector

The private sector has the potential to drive economic growth and therefore to help countries move from middle-income to high-income status. A thriving and open private sector can also be a key element in building stability and thus in reducing fragility. However, this research project has identified a number of factors reducing the ability of the private sector to do these things.

5.1 Business context

Aside from issues of elite control, the private sector in the countries studied faced a number of other challenges to growth and expansion. Perhaps the most significant are challenges of regulation, governance, and the business environment. A key marker – perhaps the key marker – of a country’s likely ability to continue a progression from poverty, and to recover from conflict, is the quality of its governance and its institutions. This study has identified clearly how the lack of functional institutions acts as a severe brake on the development of the private sector. Poor regulation, poor corporate governance, and a weak operating environment are major constraints in all the countries surveyed. This is demonstrated clearly by the generally poor (sometimes very poor) rankings that all of the study countries receive on international benchmarks for governance and transparency.

Table 1: Rankings of focal countries on key international business indicators

Indicators	Sudan	Ethiopia	Egypt	Nepal	Myanmar	Lebanon
Transparency International Corruption Perception Index 2017 ¹⁴	16	35	32	31	30	28
World Economic Forum (WEF) Global Competitiveness Index 2017/18 ranking (out of 137 countries) ¹⁵	N/A	108	100	88	N/A	105
World Bank Doing Business Indicators 2018 Overall Ranks ¹⁶ (of 190 countries) **	170	161	128	105	171	133

Lebanon, for example, is ranked 133rd out of 190 countries in the World Bank’s Doing Business Indicators. Particular issues identified by the study are resolving insolvency, where Lebanon is ranked 147th, trading across borders (140th), and starting a business (143rd). Given the small size of the domestic Lebanese market, the second of these challenges – trading across borders – might explain why many Lebanese choose to establish businesses off-shore. This means that the government loses out on tax revenues that would be generated by such businesses, and jobs are not created domestically.

¹⁴ www.doingbusiness.org/rankings | Scale: Highly corrupt (0-9) ←-----→ (90-100) Very clean

¹⁵ www.transparency.org/news/feature/corruption_perceptions_index_2017

¹⁶ www3.weforum.org/docs/GCR2017-2018/05FullReport/TheGlobalCompetitivenessReport2017%E2%80%932018.pdf

The WEF Global Competitiveness Index ranks Egypt 115th out of 138 countries studied, and identifies major rigidities that plague its goods, labour, and financial markets, on which the country ranks 112th, 135th, and 111th, respectively. Egypt performs particularly poorly on the quality of its macroeconomic environment, where only four other countries perform worse.

The World Bank's 2017 Doing Business Report showed Sudan's performance deteriorating. Sudan ranked 168th in 2017 out of 190 countries (it was ranked 153rd in 2014). Around 64.7% of the companies surveyed identified corruption as a major constraint to doing business,¹⁷ while 76.8% identified tax rates as a major constraint. Moreover, 21% of companies identified business regulation as the biggest constraint and 21% cited tax rates and administration. Other significant factors cited include power cuts, political instability, and informal sector competition. An unstable exchange rate and parallel foreign exchange systems, as well as high inflation, represent major risks to private sector stability. Difficulties in accessing foreign exchange and restrictions on particular types of loans make it difficult for banks to manage risk. This is perhaps the overriding constraint and the primary focus for reform. There is also limited access to financial services due to poor financial infrastructure like credit reporting and collateral registry systems. The provision of financial services is, moreover, highly concentrated in Khartoum State. There is very limited access to finance in rural areas, where no banking branches operate and potential borrowers are lacking collateral. The US sanctions constrained Sudan's financial sector's ability to engage in global financial markets, as most overseas banks sought to avoid all risk of contravening sanctions. Conflict in Darfur, Blue Nile, and South Kordofan states served to undermine investor confidence, with international investors perceiving Sudan as a risky investment environment overall but also stopping many business activities in insecure areas. That said, thanks to Sudan's links with Gulf markets and the impressive flexibility of Sudanese firms, the economy remained relatively dynamic despite these restrictions until 2018, when it has now hit a crisis.

Ethiopia also slid downward in the World Bank Doing Business Report, moving from 159 to 161 in overall ranking out of 190 economies in 2017. Ethiopia is ranked 174th for starting a business (an improvement over five years) but has seen a significant decline in the area of taxation, moving from 90th to 133rd. This is indicative of a significant burden of mandatory taxation for medium-sized business as well as costs associated with tax administration. Ethiopia remained unchanged on cross-border trading at 167 out of 190. The Doing Business Report showed Ethiopia as a top performer within sub-Saharan Africa on enforcing contracts (68/90) but other indicators remain troubling, including dealing with construction permits (169/190) and registering property (139/190). The change in taxation requirements reflects issues raised by several informants around a confused taxation system, inconsistently understood and applied to the extent that businesses may suddenly receive hefty tax demands that make their ongoing operations unfeasible, putting some out of business. While efforts to improve revenue from business are supported in general, these are not being rolled out in a systematic manner and often appear arbitrary. This is a good example of reforms needing to be joined up and regulatory reform needing to be coupled with institutional reform and capacity building to ensure sound implementation.

Myanmar ranks 171st of 190 countries in the World Bank's Doing Business survey, far behind the regional average and the lowest among our countries – just behind Sudan. Access to finance is a major constraint alongside an inadequately skilled workforce and lack

¹⁷ See www.enterprisesurveys.org/data/exploreconomies/2014/sudan (accessed 15 June 2018).

of access to electricity. Instability in the political and policy environment and the overall rule of law (including corruption and contract enforcement) are also issues, although several interviewees noted recent improvements in the legal framework. That said, constraints persist at the level of the bureaucracy due to lack of capacity and risk aversion, which means that lower-ranking staff pass basic decisions up to the highest levels in the ministry, leading to delays and distracting senior officials from more strategic matters.

5.2 Elite interference and corruption

In practice, large areas of the private sector in the countries studied are not really competitive enterprises but are controlled by elite groups and derive their profits from rents extracted due to their size and power as well as a distortionary policy environment. As well as the official state-owned enterprises that dominate in, for example, Sudan and Egypt, there are also significant business interests controlled by the army, government ministers, or groups close to either of these. This situation is compounded by often-severe corruption.

In Ethiopia, the government recognises that private companies play an important role in realising the country's development objectives but there is huge concentration of market power in the hands of party-affiliated companies and public enterprises. The process of privatisation, underway since the early 1990s, is heavily influenced by political considerations and progress has been slow. The legacies of the previous socialist system have been hard to shake off. There is a dominance of formerly state-owned enterprises as well as of enterprises with links to the military and to key political allies, while ethnically connected business elites thrive. These discourage new entrants to the market among the Ethiopian private sector, which remains small. Space for what might be considered the 'real private sector' is limited. Investment decisions appear to be influenced by an assessment of whether politically connected or state-owned enterprises would move in to claim the space created. This was one reason given for the dominance of real estate investment and large construction projects in urban centres rather than productive or trading enterprises elsewhere, which are seen to have greater risks as well as more fierce competition. Without a level playing field, the appetite for risk is low among the domestic private sector.

Similarly, in Sudan, state ownership of enterprises, direct and indirect, at national and state levels, distorts markets, as the presence of state firms provides a strong disincentive to private entry (AfDB, 2016). It was noted that a body of nominally private sector entities had developed around the ruling party since 1989, winning state contracts and gaining favour in return for political support. These were distinct from the handful of longer-established large family companies that were able to thrive without explicit political alignment, often due to the extensive social and political networks they have so that, while they are politically engaged, they are not politically aligned *per se*. Furthermore, military and security forces have spun off a number of companies that the state appears to protect. Newer, smaller businesses described a need to carefully navigate this space in order to avoid what they consider ethically unacceptable practices. This appeared to be less problematic among younger business people in newer creative industries where competition from traditional industries is less of a factor and space cannot easily be claimed by like-for-like businesses.

In Lebanon too, elite control over key sectors of the private sector is considerable, with similar distorting results on the private sector and on the efficient functioning of the economy. Lebanon performs very poorly on international corruption indices. For example, Transparency International's Corruption Perception Index places Lebanon 143rd out of 180

countries surveyed.¹⁸ In interviews, it was reported that most senior politicians have significant private interests, which they use their political position to favour. Prime Minister Saad Hariri, for example, remains the Chairman of Saudi Oger, which was established by his father in 1975. Saudi Oger has interests in construction, real estate development and telecoms and facilities management.¹⁹

Elite control also operates in ways other than ownership of companies themselves, as the electricity supply in Lebanon illustrates. Most of the country lacks round-the-clock grid electricity and load-shedding schedules are posted in many buildings.²⁰ As a result, many people are obliged to pay for additional power from privately owned generation companies, who in turn pay kick-backs to those in political power. According to an *Economist* article on this subject (2015), 'generator owners in Beirut's southern suburbs say that, in order to operate, they must pay a fluctuating monthly fee to street-level officials of local Shia militias, which are also tied to prominent political parties. The same goes for many towns and villages, whether Christian, Muslim or Druze'. It was also reported in a number of interviews that these private generation companies lobby hard to prevent the improvements in the grid power system that would undermine their market position.

In Nepal, the formal economy is controlled by a group of family-owned conglomerates or 'business houses' that are dominated by certain caste groups, particularly the Marwadis and the Newars. These business houses are well connected, both to each other through family and marriages and to the government. Leaders of business houses have also recently been entering politics. As a result of their connections, business houses benefit from patronage links and subsequent policy 'rents'. Informal access barriers, collusion, and price fixing are common and tolerated by regulators (Bertelsmann Stiftung, 2016). Cartels dominate many sectors, whether through proactive collusion or inadvertent interactions through close personal ties, undermining productivity and limiting contestability in the sector. Trucking and public transport associations are often held up as a prime example, with explicit price fixing, use of worn-out vehicles, and overloading of cargo. A series of government regulations and quotas help perpetuate this system and restrict free entry into the sector. The net effect is to deter foreign investment and new domestic entrants and to obstruct the development of the vibrant and dynamic transport sector. The high cost of production (linked in part to cartels) and low productivity in the Nepalese economy undermines economic competitiveness and job creation.

In Myanmar, the processes of political and economic transition since 1988 have enabled the emergence of a group of companies from being largely military cronies into an oligarchy whose power is no longer dependent on these connections (Ford *et al.*, 2016). These conglomerates benefitted from two waves of privatisation that allowed them to consolidate dominant positions in many markets. As they have gained economic power, their ability to actively influence politics has also grown. They continue to defend and benefit from regulations that make accessing the economy difficult, such as rigid licensing and permits, restricted bank lending rules, and government-controlled interest rates. Even the recently elected civilian government appears to have recognised the conglomerates as a reality to be worked with rather than opposed, since they retain considerable structural power that limits the options of policymakers. Some of these conglomerates are led by those retaining strong

¹⁸ See www.transparency.org/country/LBN (accessed 14 June 2018).

¹⁹ See www.bloomberg.com/research/stocks/private/people.asp?privcapId=1611621 (accessed 15 June 2018).

²⁰ Indeed, so prevalent is the problem that an app has been developed to provide users with advance warning of power outages: <https://itunes.apple.com/gb/app/beirut-electricity/id434106511?mt=8>

personal links to the military, including military officers themselves.²¹ Recently, a handful of those companies with a more commercially minded or reformist leadership have been seeking to clean up their reputation and legitimise their role in the economy, potentially to strengthen their future competitiveness. This may create a more suitable opening for those seeking to influence the *status quo* given that a direct challenge is unlikely to succeed.

However, corruption can affect the private sector in other ways too. In Egypt, a key challenge is the ability to hire properly qualified staff and central to this challenge is corruption and inefficiency in the education system. A number of interviewees argued that, because many teachers are poorly paid, they increase their income by tutoring young people. This means that the quality of education in state schools is falling, with tutors available only to those whose families are able to pay. This growing skills challenge is reflected by Egypt's poor ranking in the WEF Global Competitiveness Index (112/138). Resultantly, even if Egypt were able to create jobs, the skills base may not be there to take them up.

5.3 Military control

In Egypt, the challenge is the gradual encroachment of the army into many different areas of the economy. As a 2014 report put it, 'the military's business activities appear to be expanding – from the manufacture of basic items such as bottled water and furniture into mega-infrastructure, energy and technology projects' (Hauslohner, 2014). In recent years, lack of foreign currency and mismanagement have regularly led to shortages of basic commodities, which the military has been able to leverage for publicity and expansion of its own businesses. In January 2017, for example, the Egyptian government reacted to months-long drug shortages and price rises for those that remained available by granting the armed forces a licence to form a pharmaceutical company. One assessment makes clear that the expansion of the armed forces into a wide range of business sectors means that, in effect, the military control the economy: 'By protecting the strategic assets of its major investment partners during periods of unrest and taking control of the bidding process for major government procurement, the Egyptian Armed Forces have become the primary gatekeeper for the Egyptian economy' (Marshall, 2015).

The expansion of military control also has significant impacts on those elements of the private sector not connected to the military. The military's access to cheap labour, resources, and influence mean that it has an in-built advantage in any area in which it operates. Many of those interviewed observed that whole areas of the economy are, in effect, no-go areas for non-connected companies, for example in areas such as construction and cement production. Furthermore, several of those interviewed observed that any new sector that appears to be expanding is likely to attract the attention of the military. This obviously acts as a significant disincentive for private actors to invest in sectors in which the military might become involved, and so make those investments untenable. Similarly, it was reported that companies resist growing too large as the military may wish to take a stake in expanding businesses.

²¹ Two of the major conglomerates are run directly by the military: the Myanmar Economic Corporation (MEC) and the Union of Myanmar Economic Holdings Ltd (UMEHL).

5.4 The structure of the private sector

In all the countries studied for this report, challenges also exist in relation to how the private sector is structured. These problems include a lack of middle-sized companies able to link large ones with small ones, an uneven spread of corporate activity across the country, and a desire to focus on high-profile 'prestige' projects rather than on creating job-rich economic development.

Most countries studied have a private sector in which there is a missing middle – there are instead a small number of large companies (often preferentially owned by members of the elite) and a large number of small ones. In Egypt, for example, there are an estimated 2.3 million companies, of which around 90% are thought to be micro-enterprises or SMEs (AfDB, 2015). By contrast, there is only a relatively small number of large companies, including locally held conglomerates such as Orascom and a number of foreign multinationals operating in the country. This was also particularly noticeable in Sudan, where one informant challenged the researcher to find a 'mid-sized company'. The few large, well-established companies appear to grow ever larger and to some extent monopolise key sectors. Newer entrants do not appear to have space to grow as they come into competition with established business as well as politically connected enterprises. In Myanmar, there is no indication that the political and economic changes underway are leading to a significant growth in business start-ups, with access to capital again a major constraint (Amine and Stockmann, 2015). In Nepal, SMEs find it difficult to enter and survive and there has been an ageing of firms over time. Based on World Bank Enterprise Surveys in 2008 and 2012, the average firm age in Nepal increased by 4.6 years, i.e. by the time elapsed between the two surveys. This suggests that either no new firms were formed or that newer firms fail to survive (World Bank, 2018a).

There is also a tendency for the private sector to be focused heavily only in some parts of the country. In Egypt, the focus is on Cairo, Alexandria, the Nile Delta, and the area around the Suez Canal. In 2015, the Egyptian government launched the Suez Canal Economic Zone, which plans to create an industrial and logistics hub surrounding the canal. Work is underway to expand and develop the zone's ports, so they can handle bigger vessels and accommodate activities such as trans-shipment, with the facilities to handle, store, and repackage cargo. Tunnels are being dug under the canal to improve connectivity between its two banks. However, this type of prestige project will not address the challenge of providing jobs to the majority of the population, who live further south in Egypt and who will not benefit at all from any further development in the Canal Zone. Alaa Arafa, of Arafa Holding, one of Egypt's biggest garment exporters says proximity to labour is more important than being near a port: 'It is no good building a factory then transporting people to work in it' (Saleh, 2017).

This focus on prestige projects, rather than working to drive economic development in the poorer, southern areas of Egypt, risks further exacerbating the gap between the haves and have-nots in the country. As noted in the previous chapter, perhaps the most significant ongoing risk to Egypt's stability is that posed by the rapid expansion of the country's population. Even though the youth bulge has yet to fully make its presence felt in the labour market, youth unemployment reached 26.7% in 2016. While inefficiencies in the labour market itself exist, a central problem is a miss-match between labour supply and demand. A recent survey by the International Labour Organization showed that around 48% of Egyptian young people are working in jobs that do not match their education, while 8.8% are

overeducated for their role and so earn less than deserved, and 39% are undereducated, which has an adverse effect on their productivity (Barsoum *et al.*, 2016).

Similarly, in Sudan, business is centred on Khartoum as well as on agriculture along the Nile Valley and trading through Port Sudan. Rain-fed agriculture is found in the west, including in Darfur, but is underdeveloped. Areas that remain conflict-affected are also economically marginalised. Given ongoing insecurity, this appears self-perpetuating and risks deter investment.

In Ethiopia, industry centres on Addis Ababa and other major urban centres and business is owned by elites. Current government industrial policy is creating industrial parks in different locations, which aim to attract both foreign and domestic investment and create jobs in strategic locations through the country (albeit primarily extremely low-paid manufacturing jobs). However, marginal areas such as Gambella, Somali area, and the south see little large-scale private sector activity. At the extreme, some pastoralist areas have virtually no market economy as nearby towns are out of reach with poor infrastructure and goods are not available locally. However, elsewhere in some pastoralist areas trading does occur, including cross-border trade in meat.

There appeared to be hopeful signs of a generational shift in terms of creation of new businesses with the establishment of small creative, highly skilled, and knowledge-based industries, including in ICT, marketing, fashion, the arts, and events in Ethiopia, Myanmar, and Sudan. These often rely on returning diaspora ('repats' as they are known in Myanmar) or in the case of Ethiopia also educated people who do not see formal jobs available to them and are no longer attracted by the civil service. Such businesses do not impinge on existing business space in traditional industries. Innovative programmes to support entrepreneurship can help harness energy in this regard.

6 Tasks and roles in PSD

In this chapter we now turn to the question of what PSD programming is needed in countries that are both dealing with fragility and seeking to continue their growth through middle-income status. This chapter also explores the other actors with whom development agencies collaborate.

6.1 Tasks

PSD programming has clear tasks to achieve and these need to be incorporated into the wider development trajectory of the host country. These are discussed in turn in the subsections that follow.

6.1.1 Macro-level coordination

PSD cannot operate on its own, but rather needs to be intrinsically linked to areas such as governance, peacebuilding, education, etc. As one interviewee said, when operating in a low-income country, it is often possible to design PSD interventions in such a way as to avoid wider issues of corruption and political competence and control. On the contrary, in middle-income countries and FCS these issues are unavoidable. Sensitivity is needed to tackle these issues as part of the wider 'development equation'.

However, despite greater efforts on the part of development organisations to bring together people working on different issues, the evidence of this report is that more work is still needed in this regard. At a workshop held to discuss the initial findings of our study, a number of those attending observed that working with the private sector is still not seen as a priority for those working in peacebuilding. A number of those interviewed in-country suggested that the obverse is also true, i.e. that PSD programmes do not always take proper account of the conflict dynamics, and different streams of programming are not always coherently focused on addressing the roots of fragility.

While not directly PSD related, macroeconomic stability is an important ingredient in the development of a strong economy. In recent years, support from international financial institutions has been crucial in keeping some of the countries studied from bankruptcy. In the case of Lebanon, the recent Cedre IV conference in Paris provided nearly \$11 billion in soft loans and grants. In November 2016, the Executive Board of the IMF approved financial assistance for Egypt in the form of an Extended Fund Facility arrangement for \$12 billion. Funding was also forthcoming from bilateral donors and is widely credited with having stopped the country collapsing.

In Sudan, DFID has identified the urgent need for macroeconomic reform as a precursor to serious private sector engagement. While some Sudanese businesses have been adept at navigating an extremely challenging macroeconomic environment with problems accessing foreign exchange, highly variable exchange rates, and a lack of formal financing mechanisms, overall these are barriers to new investment. Similarly, in Ethiopia a lack of access to foreign exchange markets was cited as one of two key barriers to the private sector.

6.1.2 Investment climate reform

As we noted in the previous chapter, all the countries studied fare badly (some very badly) on international benchmarks of the business environment. This is likely to be a factor in most countries struggling to maintain or create peace, and to grow their economy.

Unsurprisingly, therefore, efforts to reform the business environment have been and continue to be a key part of the work of the international development community, albeit in circumstances where vested interests mean that change can often be challenging to achieve. This challenge seems to mean that donors are ‘picking their battles’, working on issues where they feel they have some degree of leverage with the country authorities, and where change will deliver visible and meaningful impact. In Egypt, for example, the international community has been working on regulations to make setting up, investing in, and closing down businesses more straightforward. As well as a new bankruptcy law, other developments include a new investment law (of which one interviewee observed, ‘it’s not perfect, but certainly a step in the right direction’), and work to make it easier for companies to formalise. In Lebanon, too, the international community is working where it can to improve the business environment. Recently, the parliament passed a budget – the first time in 12 years that this has happened – and, even though, in the words of one interviewee, ‘there is still a marked lack of detail, it does provide a bit more transparency’.

In Myanmar, despite the desperate need for reform of a dysfunctional banking system and early optimism for change, political and economic elites have blocked change, meaning that reforms that are ready to go technically have nonetheless been languishing. On the other hand, the United States Agency for International Development (USAID) has had some successes in supporting motivated officials within the Financial Regulatory Department on micro-finance sector reforms. Their work included providing tools and guidance (e.g. evidence, modelling, training, and advocacy support) to motivated officials.

The WBG Doing Business Index places Sudan in the bottom quintile and shows that the pace of business regulation reforms has remained limited in recent years. Sudan’s score indicates there is significant room to improve the efficiency and quality of business regulations, particularly ones that impact SMEs. Over the past decade, Sudan has been slower than most of its peers in the sub-Saharan Africa region in reforming the business environment. Nevertheless, progress has been made with international support. For example, a private credit bureau was established in 2013. Two years earlier corporate income and capital gains tax rates were reduced and labour tax abolished. It also became easier to file customs declarations online. Although Sudan outperforms neighbouring economies such as Chad and the Central African Republic, however, the pace of reform is insufficient to close the gap with most African economies. Across Africa, governments that made significant and sustained progress in business environment reforms have tended to have vision and support from high levels of the government and a comprehensive approach to the reform agenda, including oversight committees to coordinate and maintain momentum. As the Government of Sudan is considering embarking on a comprehensive reform agenda, moves are afoot to establish a high-level oversight committee to facilitate effective coordination of efforts among various stakeholder agencies and line ministries as well as technical groups incorporating the private sector.

6.1.3 Developing a thriving private sector

All countries need to develop a private sector that employs people, pays salaries and taxes, and so facilitates broad-based economic growth. It is clear that the private sectors in the countries studied are a long way from being able to do this. However, this chapter has identified a number of key steps that might be taken to support this longer-term process.

The first challenge is to identify points of access. In the countries studied, large areas of business are controlled by elite interests. In the short term, little can be done about this as these companies will be part of the structures of political control. Much more relevant is to identify where opportunities exist to work with companies that do genuinely create incomes and jobs for the population as a whole. This may be by looking at new sectors such as tech-based businesses, or by understanding how to drive investment into areas of the country currently being ignored.

It is also important to be entirely realistic about what reform might be possible. In all the countries studied, a great deal of work is needed to reform the business environment and to provide a playing field that is level enough to encourage more investment. In principle, addressing these issues should be a priority; however, in practice it may be that large areas of reform will be off-limits because of a perception that they might undermine elite interests. Nevertheless, by working with business organisations it should be possible to identify a key set of reform issues that would lead to economic benefits that form a clear win for the host government.

Finally, underpinning both of the points above is the need to understand where, even in the absence of a widespread willingness to reform, it is possible to leverage the support of government and others to push forward on specific areas of change. In Egypt, for example, the government knew that it needed to be able to demonstrate progress on key reform areas to keep international funders happy. Conversely, by pushing too hard on independence for the Central Bank in Myanmar, international pressure backfired in terms of implementing reforms. Development actors need to have a very clear picture of where leverage exists and where change, even if limited, is possible.

6.1.4 Support direct to the private sector

The challenge of getting change to happen at macro-political and policy levels means that a good deal of development work is focusing on the private sector itself. This takes numerous forms. First, there is a focus on 'new' sectors. In some of the countries studied, 'traditional' sectors such as utilities, construction, and communication are under the aegis of elite groups. As a result, donors are working in new, innovative sectors such as IT and technology. In Egypt, for example, DFID, the IFC, and others support tech hubs such as Flat 6 Labs, which is an incubator for companies working to develop online products. The aim of the Lab is to develop companies to the point where they can access venture capital or private equity funding. Second, donors are focusing on developing funding streams for SMEs, often using approaches rather different from the standard challenge fund or micro-finance models that might be used elsewhere. In Lebanon, for example, donors support Kafalat, a local company that assists SMEs to access commercial bank funding. In its own words, Kafalat helps SMEs by 'providing loan guarantees based on business plans and feasibility studies that show the viability of the proposed business activity'.²² Its processes

²² See <http://kafalat.com.lb/about-us> (accessed 14 June 2018).

guarantee applications for loans that are to be provided by Lebanese banks to SMEs operating throughout Lebanon.

In Ethiopia, the government's industrialisation policy, creation of industrial parks, and use of incentives to attract foreign investment are impressive, coupled as they are with attention to labour and environmental standards, job creation, and definition of a niche for Ethiopia compared to other emerging economies that could help establish foreign investment over the longer term rather than encouraging short-term enterprises. However, in order to capitalise on this, ensure sustainability, and foster inclusive growth, support to agricultural value chains is needed to supply the market, reduce reliance on imports, and revive economic activities more widely. Some NGOs and multilateral entities were supporting this but not at the scale required. In Sudan, by contrast, there was consensus that agriculture is where the country's economic potential lies and key private sector entities were attempting to garner government support. In some cases, Sudanese businesses were themselves seeking to nurture value chains and make connections between big business and small enterprises, for example through contract farming. However, the top-level leadership is lacking. Greater support is needed for these good business practices where the private sector themselves hold a vision for broader development.

In both Sudan and Ethiopia, there was evidence that newer industries stood greater chances of thriving as they pose less competition to established players and rely on specific knowledge that cannot be easily replicated. Donor support to entrepreneurship in technology and creative industries is a viable strategy, particularly with a focus on youth who are often highly qualified but without job opportunities. With formal job opportunities not matching entrance to the job market, an increase in the proportion of educated youth, and decline in attractiveness of the public sector, support to entrepreneurship is essential in creating the next generation of businesses.

6.2 Roles

However, what is also clear from this study is not just what tasks need to be undertaken but how different organisations need to work together to achieve them. DFID and agencies like it are not working alone; they need to coordinate their activities with a wider range of entities.

6.2.1 'Patient capital' and private equity

It is important to collaborate with other development actors – be those other donor agencies, investors, local companies, or others. Countries facing the challenges of middle-income status and struggling with conflict issues are inherently risky, and seen by potential investors as such. It was notable that more than one foreign embassy in Beirut observed how challenging companies found the operating environment there. Patient capital instruments, and institutions such as the UK's CDC and PIDG, could be used to act as a bridge away from Official Development Assistance (ODA)-based programming toward more fully fledged private sector engagement by de-risking investments and demonstrating that successful business is possible.

In both Myanmar and Nepal, the large domestic conglomerates are in cosy relationships with government officials and have ready access to sources of finance, while the majority of SMEs have little access to finance for investment or working capital. Both countries have seen an influx of new forms of private equity and growth capital. At the lower end are SME

accelerator funds like Business Oxygen in Nepal and Rockstart, active in both Nepal and Myanmar, which supports SMEs to access funds in the range of \$100,000 to \$500,000 from impact investors, alongside management support. At the other extreme are impact funds such as Dolma Impact Fund in Nepal or the Insitor Impact Asia Fund in Myanmar (which includes some funding from CDC), which make equity investments in early and growth stage companies of up to \$4 million. In the case of Insitor, the focus is on companies that deliver products and services that can improve the living standards of low-income populations in areas such as water, food, shelter, education, healthcare, energy, and finance. These funds all tend to apply some form of environmental, social, and governance criteria to their investments, as well as seeking a social impact alongside financial returns. Conflict analysis is not part of the screening, although the funds would argue that their investments do not tend to fall in conflict-affected parts of the country. In both countries, several interviewees expressed scepticism regarding grant-based funding models (e.g. challenge funds), which they perceive as either having little impact or as distorting the market. That said, these impact funds are relatively new and the development impacts of investments made so far, or their relationship to conflict dynamics, have yet to be adequately assessed.

6.2.2 South–south collaboration

It is important to acknowledge the very different approaches to engagement taken by different international actors, the significant impacts these have, and the need, therefore, to foster better working relationships between traditional donors and newer powers in development. Most notably, China has a significant presence and impact in all countries under study both as a donor and lender and as an investor. In contexts where relationships between western governments and the host government have been tense, and in the case of Sudan with formal sanctions, non-western donors may have closer working relationships in country. In Ethiopia, it was noted by many informants that the approaches of OECD Development Assistance Committee (DAC) donors are focused very much on regulations, the promotion of international norms, and ‘soft’ support to improve the operating environment, government capacity, and business practice. At the same time, many non-DAC donors are present and have close relationships with the Government of Ethiopia – most notably China. These actors operate in different ways, often being more operationally focused on providing physical infrastructure. It is essential that dialogue between different bilateral actors is ongoing to understand how these approaches to developing the private sector can be complementary. Similarly, coming out of sanctions in Sudan, most DAC-donor bilateral agencies have little PSD programming and weaker relationships with the Sudanese government but a legacy of humanitarian response for which there remains enormous need. With international support having come primarily from non-DAC donors over the past few decades, and increasing economic interests from longstanding partners and new allies such as Qatar, Turkey, and Russia, it is essential that both donor programmes and potential investment support engagements from different countries take each other’s activities into account. DAC donors should consciously seek to build relationships with Middle Eastern and Asian aid and trade missions.

In FCS where government capacity and will to support social outcomes is low, private sector actors may take on social functions. In the case of Sudan, a strong culture of social responsibility and philanthropy traditionally plays out in charitable giving but for some key businesses this is shifting from small and scattergun initiatives toward more strategic social engagement and alignment with the SDGs and efforts of international donor agencies. Recent efforts to broker discussions between the donor community and Sudanese

companies show a promising new model of engagement. With government capacity so low, the private sector fills gaps and a small but committed group of socially engaged businesses appears to be emerging. Support to bring these business entities together with other actors supporting efforts to achieve the SDGs is essential. These private sector companies bring broad physical reach across the country, linkages with small business at community levels, and experience of designing and implementing 'social enterprises' with social impacts at the heart of business. They also bring longstanding experience of navigating the politically charged context and of getting things done in an extremely difficult and complex environment.

6.2.3 Flexible and adaptive programming

The complex and sometimes fast-changing context of countries affected by conflict calls for a different type of PSD programming, which prioritises flexibility and adaptive management over technically driven solutions. For example, the DaNa ('prosperity') Facility, funded by DFID in Myanmar, is designed as a flexible programme that works across firm, sector, sub-national, and national government levels and which aims to be able to respond rapidly to promising opportunities and requests for assistance.

While adaptive programming has become something of a mantra that is sensible in theory but difficult in practice, Nepal's Economic Policy Incubator (EPI) programme has been singled out as a programme that is genuinely 'doing development differently' (Booth, 2018). While it is still early in the life of the programme (it started in 2016), EPI has had some 'early wins' in terms of rapid and significant progress toward improving the investment climate in Nepal. These include helping to overcome blockages to a law on special economic zones that had previously been held up in parliament for eight years.

However, what is clear from the countries studied is that the stakes are extremely high. However undesirable the *status quo* might be, alternatives could be very much worse. The structure of Lebanese politics is certainly corrupt, and the need to seek consensus means that getting things done is slow, if not virtually impossible. Yet however problematic this structure might seem to outsiders, it has nevertheless provided stability despite the huge pressure exerted by the influx of refugees. One interviewee described Lebanese politics as a 'black box' that defies external analysis while still working. Those planning PSD and other donor support need therefore to be very careful in tackling issues that might disturb this delicate balance. Indeed, one interviewee observed that a key reason why the Cedre IV conference did not apply more conditionality was that the donors did not want to push Prime Minister Hariri too hard lest he lost too much face relative to the other power groups in the country.

Development work, therefore, needs to be undertaken on the basis of a clear analysis and understanding of the situation a country or particular region faces, and to be aware of the importance at least of not making the situation worse. Donors and private investors need to recognise that the decisions they make (including the decision to follow the law) are not neutral, creating a need to better understand and respond to the views of different groups. Of course, 'do no harm' can sometimes translate unhelpfully to 'do nothing'. Economic development and poverty reduction remain important, including in conflict-affected regions. Given inevitable limits to donor understanding of complex conflict dynamics, adaptive and responsive programming that starts with a range of small interventions with real-time monitoring to build experience of what works and what is counter-productive again offers a

way forward. Working with partners that are trusted by local populations, engaging conflict specialists (from within or outside the organisation), and employing local staff are other components of good programming. The focus should be on identifying a point of entry at which change – even if on a small scale – can be achieved. What was also stressed was the need to take small steps with the aim of demonstrating that change need not be detrimental to vested interests.

7 Conclusions

This chapter draws together the findings of this report to draw conclusions about the challenges faced by fragile, middle-income countries, and how these might be addressed.

7.1 Regional issues matter

Countries cannot properly be understood without attention also being paid to the region in which they exist. Both in terms of conflict dynamics and the potential for beneficial economic linkages, an individual country's destiny is driven at least to some degree by its neighbours. Nepal complains of being 'India-locked', and the policies and approach of its huge neighbour have significant implications for the economic choices it is able to make. In Lebanon, the fragmentation of Syria has closed off one of the country's main commercial axes to the Gulf States. In fragility terms, the Syria crisis has also left Lebanon having to cope with more than 1 million refugees. However, it is clear that it is not just the reality of regional issues that have implications for individual states but also the perceptions to which regional issues give rise. In Egypt, for example, the fact that much of the region has descended into conflict makes Egyptians very keen to avoid the same fate. As a result, unpalatable though many of President Sisi's policies may be, many of his countrymen are prepared to support him because he maintains stability.

What is clear, therefore, is that PSD and other development programming cannot simply be designed just in response to domestic issues but needs to take account of the wider regional perspective. This needs to encompass an understanding both of the conflict issues – tangible and psychological – and the trading and commercial linkages that may support economic growth and development.

The need for a regional perspective is particularly the case when considering infrastructure. The case of the Nile illustrates this point well. Ethiopia's decision to build a dam has significant implications for Egypt, which is already short of water. One country's infrastructure decision can therefore have significant, and often adverse, implications for their neighbours. Conversely, well-considered regional infrastructure might actually serve to boost commercial opportunities and reduce conflict tensions. Such approaches need to be proactively considered in fragile middle-income countries because of the benefits in terms of economic potential and conflict-risk reduction.

7.2 Understanding conflict and fragility tensions is vital

There is clearly a need for detailed and nuanced understanding of the conflict and fragility dynamics in host countries to understand properly where PSD and other programming needs to be focused. Sometimes, conflict may not even seem relevant. In Myanmar, for example, there are large areas of the country that are stable and therefore in which 'business as (more-or-less) usual' carries on. In a number of the countries studied, the apparent source of fragility was not, in reality, the most significant conflict-related issue. In Lebanon, certainly the Syrian refugee crisis is a significant cause of tension, and unless carefully managed could erupt into violence. However, a more significant potential cause of tension would be the disruption of the balance between the different confessional groups in the country.

There is a need to properly understand the conflict dynamics and to identify the potential points of access. As with any conflict analysis, there is a need for a focused question and, in the case of PSD professionals, that question relates to the interaction between conflict dynamics and the private sector. In what ways does conflict impact on the private sector? In what ways do companies and other private sector institutions affect conflict, positively and negatively?

7.3 Everything is linked to everything else

PSD programming cannot exist in a silo on its own. Many of the issues PSD needs to address are themselves subsets of wider issues. Skills challenges in companies reflect wider challenges with national education systems; elite interference in the private sector reflects problematic governance structures in the country more widely; challenges with the regulatory environment are functions of ineffective government structures and a lack of capacity.

Moreover, in a fragile context, the private sector is inextricably interwoven into the conflict dynamics. For example, private sector activities can be used to fund conflict and who controls key sectors can reinforce societal divisions; on the other hand, workplaces can also bridge sectarian divides. This implies two things. First, PSD practitioners need to maintain clear sight of the conflict dynamics in the places in which they operate. Second, those working on other areas of development need to focus on the private sector, and to see PSD activities as a priority.

It is important, therefore, that development practitioners are encouraged to understand the interrelated nature of their activities in fragile middle-income countries. At a policy level, there is now a clear realisation that a failure to focus in FCS early enough on developing a thriving private sector actually risks undermining a country's longer-term stability. As USAID (2007: 23) points out, 'conflict-affected environments often experience large inflows of aid assistance early on in the post-conflict phase, which drop sharply as soon as the conflict has drifted from public and political attention. Too often, there are no systems or strategies in place to build on these initial subsidies to create lasting economic growth'. Therefore, as was argued in the 2011 World Development Report, 'we need to put greater emphasis on early projects to create jobs, especially through the private sector' (World Bank, 2011:xiii).

Despite this, the evidence from this study is that PSD is still not seen as a priority by some in the conflict community. For them, focusing on governance, peacekeeping and then peacebuilding, and humanitarian relief are the priorities. It is important that donors (and other development actors) reinforce all the time the need to prioritise the development of a diverse private sector.

7.4 Be careful what you wish for

The international development community has a well-established set of priorities in what it seeks to achieve in countries in which it operates. These include free and fair elections, transparent institutions, and predictable regulation. These things are seen as *de facto* and *a priori* public goods that should form the core of development programming in all cases. However, what is clear from this study is that in fragile middle-income country environments the 'standard development toolkit' is not so obviously 'a good thing'. In Egypt, for example, Sisi most certainly is an authoritarian leader. However, the last time 'the west' pushed for more openness, the result was the rise of the Muslim Brotherhood. Is Sisi actually worse

than the country falling apart? In Myanmar, attempts to reform the Central Bank went badly wrong and led to the stalling of wider reforms. In Lebanon, the confession-based political system most certainly stymies reform; however, to tinker with it too much might be to risk destabilising a system that, however unlikely, does keep the country from falling apart.

It also appears to be the case that issues that, in many developing countries are important but not urgent, become much more visceral in fragile middle-income countries. Take, for example, the issue of the gap between rich and poor, haves and have-nots. This is a challenge in most developing countries but one which is neither new nor immediately likely to be destabilising. By contrast, in Egypt, the poverty of a large proportion of the population is precisely where the risk of long-term instability and potential conflict comes from. In Lebanon, evidence from household surveys strongly suggests that what would tip latent tension and annoyance over into actual fighting would be limited access to jobs and limited opportunities to earn a living.

This is not, of course, to say that international development priorities are not relevant in these countries but rather that the development community needs to recognise that the stakes in conflict-affected middle-income countries are extremely high. The fact that a country has made it to middle-income status means that at least some of the population lead moderately prosperous lives. Mishandling development interventions therefore risks not just failing to expand the number of those living in greater comfort but destabilising an often complex and opaque system such that those who currently are 'haves' become 'have-nots'. The stakes are thus much higher in these environments. If you get it wrong in these contexts, the downside is potentially disastrous.

7.5 Realpolitik

As well as understanding the conflict dynamics, it is vital for development activities to be properly informed by robust political economy analysis. Such analysis will provide clear insights into key structures of power, which in turn will help identify the potential points of access – where change might be possible on a small front, even if wholesale change is not feasible in the short to medium term. However, such analysis will also identify those issues that will require donors to accept unpleasant truths. In Lebanon, Myanmar, and Nepal, the corruption in and links between politicians and the private sector is endemic. It also, from a development perspective, has serious impacts on the country's population. For example, in the power sector kick-backs and vested interests mean that many Lebanese have unreliable energy supplies. In Nepal, the business houses resist reforms that would open key sectors to competition and development. In the power sector, for example, this means that of an estimated hydropower capacity of around 80,000 MW of electricity, out of which 43,000 are currently feasible, only 972 MW is currently installed (Office of the Investment Board, 2018). However, to seek to address these vested interests without understanding the context risks damaging a political fabric that, however problematic it might be, does maintain peace and security.

7.6 The importance of 'worked examples'

As is clear from this study, then, in fragile middle-income countries there are so many issues and complications that effecting meaningful change often seems impossible. The environment can seem so hostile that it would be easy to give way to a counsel of despair. Yet the experience of many of those interviewed for this study is that, however significant the

obstacles, change can still happen. In Egypt, despite government scepticism about the private sector, donors have been able to find enough common ground to make meaningful change on key issues of business environment reform such as the introduction of sensible bankruptcy processes.

There are a number of facets involved in addressing this challenge. The first appears to be to choose an issue that is manageable and tangible. Even if change is effected on an apparently small front, it can demonstrate both that change is possible and how change might actually happen in other places and on other issues. Second, it seems important to choose an issue where there is some support among some of the political elite – they can see that change needs to happen even if they may not relish that fact. If those who have an interest in a *status quo ex ante* can see that they can also have an (albeit different) interest in a new *status quo*, they are likely to be supportive of further change down the line. The aim therefore should be to focus on what is possible, rather than seek to effect grand change that will not happen. ‘Worked examples’ of change occurring can be used both to encourage and to inform others and to win support within elites that change can be good and beneficial.

7.7 Diagnostic questions

Following from the above, what questions might a PSD practitioner usefully ask to develop relevant and appropriate interventions? Self-evidently, each fragile middle-income country will be different and therefore the policies and interventions to be pursued will also need to be different. The following is an indicative list of questions to help policymakers to create a set of activities appropriate for their location.

Regional context:

- **Regional impacts:** In what ways, economically and in terms of stability, has the country been directly affected by regional factors?
- **Political and physical infrastructure:** What regional tensions and infrastructure plans exist or are rumoured and how might these impact on the host country?
- **Understanding perceptions:** Irrespective of the actual impacts that regional issues have had on the country, what perceptions and fears exist stemming from those regional factors?

Country context:

- **Conflict and fragility analysis:** What exactly are the different conflict and fragility dynamics, recognising that these may differ between different areas of the country?
- **Political economy:** Where does power lie and how do networks of power and influence operate in practice? What is the relationship with the private sector?
- **Gauging options for change:** Given the fragility and political situation, what is the appetite and potential for change? How far can things be shifted without undermining stability?

Private sector:

- **Political interference:** How far can the private sector operate free from adverse political interference from those in power and their associates?
- **Private sector structure:** How is the private sector structured in terms of geographic focus, sector spread, and company size? What implications does this have for creating income and jobs?
- **Establish points of access:** What are likely to be the most positive points of access to effect change that will be developmentally valuable?

PSD: Tasks and roles:

- **Focus on core issues:** What PSD interventions will best address the critical success factors, the failure to achieve of which entails most risk to the country's continued progression from poverty?
- **Joined-up approaches:** How can PSD programming be best joined up with other streams of activity not just within the development sphere but also with private and other relevant actors?
- **Focus on what is doable:** Given the challenges that exist, what is possible and doable that can demonstrate the benefit of change but which does not adversely upset the *status quo*?

7.8 Concluding remarks: Fragility means just that

The question is sometimes raised as to whether FCS are materially different from other developing countries. Are they not the same as others, just more so? This study has demonstrated that FCS do look and feel very different, and that this has clear implications for development programming in general and PSD programming in particular.

Such places suffer from elite capture, which affects both political governance and transparency in the private sector. Consequently, the rule of law is weak and the regulatory environment in which companies operate is challenging. The private sector is often skewed, with a small number of (often elite-controlled) large companies and a large number of small ones. Mid-size companies that would connect these groups together and create broad-based economic development are absent. There is also a need to see PSD as an element of a wider development approach, not as a set of activities in itself, and to collaborate with a wider set of partners.

The research has demonstrated that fragile and conflict-affected environments pose very particular challenges to the development community. First, it is clear that the regional dynamic is extremely important. From both the perspective of economic growth and from the actual or potential effects of regional conflicts on the domestic environment, it is clear that development programming needs to take account of the regional as well as the national dimension. Second, there is a need to understand precisely what the conflict issues are. As is evident from a number of countries in this study, the ostensible reason for that country's inclusion in a list of FCS states was not, in fact, the main fragility challenge. Excellent political economy analysis should be (but, regrettably, often is not) central to all development programming. It is clear that equally first-rate conflict analysis is also needed. Third, it is not just the actual impacts of conflict that need to be taken into account, so too must be the

psychological impacts. Instability has effects on the way people in a country think, and this in turn informs what they see as acceptable in their government's policies. These less tangible impacts also need to be taken into account in creating informed interventions. Fourth, and most importantly, the presence of instability means that the stakes, on all development decisions, are much higher. Situations that may appear to development specialists as undesirable – the too-close links between key politicians and large companies, for example – are often facets of a skein of overlapping networks that, however bizarrely, maintain stability. Even when addressing issues like this seems desirable, development interventions need to ensure that they do not inadvertently destabilise such networks. In most development situations, a badly designed programme risks only a poor annual review: in fragile contexts, however, a badly designed programme risks open conflict and war.

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