THE ROLE OF FOREIGN DIRECT INVESTMENT IN POST-CONFLICT PEACEBUILDING

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ABSTRACT

THE ROLE OF FOREIGN DIRECT INVESTMENT IN POST-CONFLICT PEACEBUILDING

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Key Words: Post-Conflict, Peacebuilding, Foreign Direct Investment

Civil wars and political violence can be ended by an agreement or ceasefire, sustainable peace, however, requires much more steps in the transition from war to peace. In a large extent the success of such transition depends on the success of economic recovery of a post-conflict country. Foreign direct investment is one of the main factors that can facilitate such recovery; however, the effects of such investment on the post-conflict peace are not clear. In order to understand the effects of the foreign direct investment on post-conflict peacebuilding, this thesis presents a rational choice model of strategic interactions between the state, the rebels and a foreign investor. The propositions of the model are illustrated with real life examples derived from Niger, Nigeria and Turkey. Finally, this paper argues that the most positive impact on peace is likely to be produced by FDI with high and positive economic externalities valued by the local population even higher than the redistribution policies of the state. Other possible equilibriums, however, lead either to recurrence of conflict in the short run, in case if revenue distribution activities of the government will threat the legitimacy of rebels, or to sustenance of the truce in the short run but exacerbation of the latent conflict. Based on these finding this paper provides several policy recommendations which according to this thesis can be potentially interesting and beneficial for both investors and policy makers.

ÖZET

UYUŞMAZLIK SONRASI BARIŞ İNŞASINDA DOĞRUDAN YABANCI YATIRIMIN ROLÜ

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Yüksek Lisans Tezi

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İç savaşlar ve siyasi şiddet anlaşma veya ateşkes ile sonlandırılabilir, halbuki sürdürülebilir barış, savaştan barışa geçiş süresince çok daha fazla adım gerektirebilir. Böyle geçişin başarısı büyük ölçüde uyuşmazlık sonrası ülkedeki ekonomik düzelmenin başarısına bağlıdır. Böyle bir düzenlemeyi kolaylaştırabilen önemli faktörlerden biri de doğrudan yabancı yatırımdır; fakat bu tür yatırımların uyuşmazlık sonrası barışa olan etkisi net değildir. Bu tez, doğrudan yabancı yatırımın uyuşmazlık sonrası barış inşaasına olan etkisini anlamak için devlet, isyancı ve yatırımcı arasındaki stratejik etkileşimin rasyonel seçim modelini sunmaktadır. Bu modelin önermeleri Nijer, Nijerya ve Türkiye vakalarından çıkarılan gerçek hayat örnekleri ile örneklendirilmiştir. Son olarak, bu makale, yerel halk tarafından devletin gerçekleştiği yeniden bölüşümden daha önemli olarak görülen pozitif ekonomik dışsallıklara sahip olan doğrudan yabancı yatırımın barış için en olumlu etkiyi sağladığını ileri sürmektedir. Oysa diğer olası denge durumları, devletin bölüşüm faaliyetleri isyancıların meşruiyetini tehdit ediyorsa uyuşmazlığın kısa vadede yenilenmesine yol açabileceği gibi, kısa vadede ateşkes sürdürülüyor olsa da gizli uyuşmazlığın şiddetlenmesine neden olabilir. Bu bulgulara dayanarak işbu makale, hem yatırımcılar hem de karar alıcılar için ilginç ve faydalı olabilecek birkaç politika önerisini sunmaktadır.

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CHAPTER 1.

INTRODUCTION

While a violent conflict can be ended by an agreement, stable peace requires much longer time, commitment and efforts from the conflicting parties and outsiders. Weakened by civil wars, post-conflict countries have to work hard to maintain and strengthen fragile peace. Such countries face a risk of conflict recurrence if parties are dissatisfied with the post-conflict conditions (Walter, 2004), old issues are not fully resolved or opportunity costs of war change in favor of conflict (Walter, 2010). Prevention of such risks and tackling economic grievances which are among the major causes for intra-state conflict (Collier, 2000; Griffiths, 2013; Hacioğlu, Dinçer, & Çelik, 2012) and its recurrence (Walter 2004) is especially difficult under the conditions of collapsed economy, destroyed infrastructure (Bray, 2009, p. 5) and fragile public institutions (Yelpaala, 2010). Similarly, businesses are deprived of economic and human capital (Yelpaala, 2010) to conduct healthy operations. Therefore, post-conflict regions require immediate investment to transform the region into a sustainable economy and polity. Such dire needs for investment often, however, cannot be funded by local investors in the region. Moreover, international credits also are hardly available for such regions, and often the main source of private capital in post-conflict countries comes from foreign direct investment (The World Bank, 2011a). Furthermore, the impact of such investment on the post-conflict peace-building is controversial – while private sector may provide services and linkages necessary to rebuild peaceful relations it also can reinforce war economy and lead to renewal of violence (Berdal & Mousavizadeh, 2010).

Little work has focused on the role FDI plays in consolidating peace in a post-conflict environment and especially on the conditions under which such investment contributes to peace or fuels a conflict. While foreign investment may create new jobs

and increase standards of living (Hacioğlu et al., 2012), it may also lead to unequal distribution of the benefits from investment through corrupted networks (Yelpaala, 2010) and create new or exacerbate old inequalities (Rothgeb, 1991). Some suggest that investors in post-conflict countries should implement policies contributing to income equality and increase of living standards of local population (Bray, 2009). However, as most likely investors in post-conflict countries are those from countries with 'weaker institutions and less concern about corporate social responsibility'(Driffield, Jones, & Crotty, 2012), the expectation of an investor to solve economic problems in a post-conflict country may not hold.

How does, then, the involvement of outside investors affect peace-building in a post-conflict society? In this paper we argue and theoretically demonstrate that decisions of such large investors are often crucial for the fragile balance of power in a post-civil war country. We will show that foreign direct investment can influence post-conflict country as (i) a legitimacy mechanism, (ii) a commitment mechanism, (iii) an incentivizing mechanism and as (iv) an opportunity cost mechanism influencing all three determinants of conflict recurrence stated above.

FDI has a potential of increasing or decreasing legitimacy of government and local rebels in dependence on the policies regarding foreign investors implemented by the government and on the policies of redistribution or not redistribution of revenues accrued by government from FDI. Acting as a commitment mechanism, FDI may reflect and increase governmental commitment to peace as recurrence of violence would damage image of the government in eyes of international community and thus endanger later financing. At the same time FDI may make previous commitments obsolete by changing the balance of power between the parties and increasing opportunity cost of war for one of the parties, thus triggering defection of peace by one of the parties before the power is shifted. As an incentivizing mechanism FDI may create incentive for government to keep peace in order to guarantee government's revenues related to FDI as in case of war foreign investors are likely to quit the country or at least to suspend their operations. Finally acting as an opportunity cost mechanism, FDI can create such economic externalities for local population as employment[1], improvement in infrastructure or provision of vital services and, thus, foster support for peace and

[1] The role of employment as an instrument to create opportunity cost for population and prevent their joining the rebel forces is defined by Hanson, Iyegar and Monten (2011). The authors argue that through such mechanism higher employment tends to reduce events of violence (Hanson, Iyegar, & Monten, 2011).

existing order by the population as recurrence of war is likely to lead to eliminate operations and such externalities of FDI.

Considering the possibility of mixed effects of FDI, one should also ask whether a foreign investor may deliberately influence the direction of the impact of investment. Indeed multiple policy-recommendations and analyses argue that if a foreign company brings investment of a certain type, organizes own relations with society with view to sustain peace (Campbell & Carment, N.D.), and operate in a mostly beneficial for local community framework (Yelpaala, 2010) or adhere to corporate social responsibility (Webb, 2009). Justified by such assumptions United Nation organization Global Compact launched in 2013 a Business for Peace Initiative aiming to promote peace oriented behavior of multi-national corporations in the host countries of FDI (Global Compact, 2013, p. 3).

In the following sections we will, firstly, present the conditions of post-conflict countries and of war recurrence, and the determinants and effects of foreign direct investment. Then we will present a theoretical model using a population-centric view of insurgency and explaining the strategic interactions between government, rebels and FDI with regards to population's support for the government or rebels taking in account economic effects of FDI as well. In the third section we will construct a game-theoretic model showing the rationale for such interactions and testing hypothesis derived from the theory. In the fourth part we will present a multi-case study illustrating interactions presented by the model and finally we will conclude our paper and present recommendations for future academic research and policy makers.

This research is particularly important from both academic and policy making views as it may bring clarity into the theoretical ambiguity on the impacts of FDI on the post-conflict peace building, while at the same time provide some suggestions for more effective peace-building strategies.

CHAPTER 2.

CONCEPTS AND LITERATURE REVIEW

2.1. Post-Conflict Countries and War Recurrence

a) Post-Conflict Countries and Peacebuilding

One of the ways to approach a concept of post-conflict country is to see it as a country being in a process of transition from intra-state war/conflict to peace (Brown, Langer, & Stewart, 2011). Another definition formulated by Junne and Verokren (2005) sees post-conflict stage as a 'conflict situation in which open warfare has come to an end', though the relations remain 'tense' (Women Win, N.D.). Both approaches underline that such transition (or conflict stage) is often interrupted by sparks of violence or recurrence of war. Moreover, a post-conflict period may include multiple steps of peace building including signing of agreements, ending of violence, disarmament, state building, social integration and many others (Brown et al., 2011).

Post-conflict countries may differ according to the levels of economic and human development, owning of natural resources, existing inequalities and capacity of political institutions (Brown et al., 2011).

However, despite some internal differentiations post-conflict countries are 'fundamentally different' from stable developing states (USAID, 2009). Post-conflict countries can be characterized by fragmented societies, unresolved issues of previous conflict, presence of mobilized and armed groups and collapsed or damaged systems of governance and destroyed infrastructure and human and physical capital (UNDP, 2010). Other common features of these countries include lack of security, high unemployment, weak administrative capacity of the state, hardships experienced by women and presence of external parties, such as donors or aid organizations with different and sometimes conflicting agendas (USAID, 2009, p. 5). In comparison to other countries such conflict induced problems make it more difficult for post-conflict states to

establish effective state structure and increase own level of economic and human development.

In order to tackle these problems and to sustain peace, states have to focus on reconstruction, reconciliation and development. Reconstruction activities are necessary to improve life conditions and motivate economic recovery. Reconciliation is necessary to transform hostile relations between different groups into more harmonious and constructive ones. Developmental programs in turn are initiated to ensure sustainability of post-conflict peace after donors and aid often given to a country immediately after settlement are withdrawn.

However, such goals are hardly possible with collapsed economies and low state capacities. On this stage peacebuilding activities are implemented in order to sustain peace and help states to improve own capacities. Peacebuilding in turn can be defined as 'identification and support of measures needed for transformation toward more sustainable, peaceful relationships and structures of governance' aiming to prevent conflict recurrence (UNDESA, n.d.). Such activities include 'demobilization and reintegration of soldiers, de-mining, emergency relief and food aid, to the repair of roads and infrastructure' (Bigombe, Collier, & Sambanis, 2000, p. 326) Improving of state capacity is crucial as it relates to legitimacy of a state and its effectiveness (UNDP, 2010). State's legitimacy, in turn, is partly dependent on the state's ability to address infrastructural problems and state service related needs of citizens (UNDP, 2010).

b) Causes of Conflict Recurrence

Though description of post-conflict countries presented above shows their vulnerability and weaknesses, it does not explain why parties, which have reached a settlement even under such grave conditions, may prefer to use violence again. Existing literature presents multiple explanations for duration of post-conflict peace and conflict recurrence.

Some argue that the duration of post-conflict peace is dependent on the duration (DeRouen, Bercovitch, & Wei, 2009) of or the concentration of violence (Morey, 2009, p. 336) during the preceding conflict. Alternative explanation proposes that rebels' victory or negotiated settlements tend to result in a more sustainable peace in the long run, while governments may maintain peace only if they are able to address grievances and ensure economic wellbeing of the population supporting or having potential to

support or join rebels (Mason, Gurses, Brandt, & more.. 2011, pp. 182,187). In contrast other studies show that military victories with support of peacekeeping operations and power-sharing agreements are likely to lead to longer peace comparatively to that following negotiated agreements (Ohmura, 2011), while power-sharing agreements alone are also found to lead to longer peace (Hartzell, 2009; Hoddie & Hartzell, 2003) in some cases and to undermine duration of peace if they are too difficult to implement (DeRouen, Lea, & Wallensteen, 2009).

Other scholars link the duration of post-conflict peace to the inclusivity of peace settlements (Nilsson, 2012), relation in post-conflict settings between the state and the ethnic group who acted as opposition and economic and political discrimination of such ethnic group (Mehmet Gurses & Rost, 2013) or individual dissatisfaction, hardships and inability to change such conditions (Walter, 2004). Moreover, such factor as high dependence on natural resources can lead to criminal or political rebel activity, while lack of alternative economic opportunities and ethnic dominance (with 45-80% of population being from the same ethnic group) constitute just another potential for conflict (Bigombe et al., 2000, p. 326). Economic grievances in particular are seen as a major cause of civil conflicts and (Collier, 2000; Griffiths, 2013; Hacioğlu et al., 2012) and their recurrence (Walter 2004)

External impacts might influence, positively or negatively, the chances for the recurrence of a conflict as well. External actors joining the conflict or post-conflict settlement are likely to introduce change in the status quo or the perception of status quo. Changes in material conditions or relations might lead equally to conflict initiation, mitigation or transformation (Mitchell, 2005). In contrast changes in expectations under constant material conditions might lead to the feeling of relative deprivation and thus spark a conflict (Pruitt & Kim, 2004). On the other hand, relational changes such as creation of new ties or increase of mutual trust might help to achieve conflict transformation (Kriesberg, 2011).

Such relational changes prolonging peace can be related to the effects of mediation (M Gurses, Rost, & McLeod, 2008), or peacekeeping efforts (Fortna, 2003, 2004; Hoffmann & Schaffer, 2009; Jung, 2006; Mason et al., 2011). Such third-party interventions may influence the duration of post-conflict peace through increasing trust in the possibility of peace and thus reduce the credible commitment problem. An

external factor that may change material conditions related to power balance or its perception and thus put initial peace deal in danger is humanitarian aid; however, such negative effect of aid is most likely in cases that ended with decisive victory, while aid is least likely to decrease the span of peace after 'truce, negotiated settlement or military stalemate' (Narang, 2014, p. 458).

Investment and particularly foreign investments into a post-conflict economy also constitute a type of third-party intervention into post-conflict situation and may potentially influence the peace or recurrence of conflict between the parties. Foreign investment is seen by some as an 'engine for economic development' (Appel & Loyle, 2012) so necessary for development of state capacity and for tackling economic hardships, which are often cited among the main reasons for conflict recurrence and endurance.

2.2. Post-Conflict Economy and Investment

a) Post-conflict Economy

The literature mentioned above highlights that economic conditions tend to have an impact on conflict recurrence and that such needs should be tackled in order to build sustainable peace. Economy is particularly important for post-conflict countries as even after settlements economies still experience such economic shocks such as 'brain drain and capital flight' (Yelpaala, 2010) due to real or perceived lack of safety and economic prospects. Conflicts impose such damages on economy as loss of human capital due to death and migration of people, destruction of property and due to the transfer of economic resources during the war-time 'from productive investment in human and physical capital to that of destructive military activities' (Hanna, Hammoud, & Russo-Converso, 2014).

While conflicts often lead economy of a country into a crisis, recovery of such economy to its pre-conflict level may not be optimal as most conflict countries had 'flaws' in their economies even before internal conflicts had broken out (Bray, 2009). Such flaws might include extensive centralization, wealth monopolization and unequal distribution of resources and the like (Bray, 2009, p. 3). Thus, a post-conflict economy might need to develop in a direction different from that followed before the conflict. However, developing economic sector in such countries is particularly difficult as the

main source of private capital in conflict affected countries is FDI as international credits are mostly not available for such risky regions (The World Bank, 2011a, p. 34). Moreover, FDI in such countries plays an important role in 'capital formation' substituting for the lacking capital and inventories (The World Bank, 2011a, p. 34). Existence of such private capital is important for diversification of economic activities and thus decrease of economic risks and development of sustainable economy (The World Bank, 2011b, p. 50).

However other problems of post-conflict countries create obstacles for FDI as well. Once conflict ends, post-conflict countries often find their public institutions at least partly dysfunctional or fully collapsed (Yelpaala, 2010). Maintaining political stability is just another problematic feature of post-conflict conflicts, as such countries may experience continuation of security and regulation problems, corruption or poor infrastructure (Bray, 2009, p. 5) An example for such conditions provides Bosnia and Herzegovina witnessing calls of separation of some of its regional entities, legitimacy problems of different governmental bodies and risks of fragmentation (Zelenaj, Beriker, & Hatipoglu, Forthcoming).

These additional problems tend to constitute obstacles for economic development and create additional risks and costs for investors. The next section will present why despite such risks investors might still be interested in entering in a post-conflict economy and what the general determinants of FDI inflows in a country are.

Investment and particularly foreign direct investments can sometimes constitute a source for economic recovery and development (Dollar & Kraay, 2001). Economic recovery, in turn, leads to an 'increase in employment and income level' and is linked to the lower risk of future conflicts (Hacioğlu et al., 2012). On the other hand, activities in private sector sometimes may increase the risk of conflict by creating tensions between groups unevenly benefiting from the economic recovery induced by businesses (Bray, 2009, p. 17). Moreover, natural resources FDI entering a post-conflict country may lead to capital flight or the 'wrong type' of FDI or cause such problems as the Dutch Disease[2] or resource curse leading to further stagnation of domestic economic sector

[2] 'Dutch disease ' refers to a situation when in a country rich with natural resources, resource-led exports lead to appreciation of the domestic currency's real exchange rate, 'contraction of the traded sector and expansion of non-traded sectors' (Van der Ploeg, 2011, p. 122). Such situation makes manufactured goods less competitive on a global market and can eventually lead to stagnation of the whole productive sector. The first country to experience such

and thus increasing the risk of conflict recurrence. Nigerian conflict exemplifies such risk as even after an amnesty program and demilitarization process initiated in 2009 separate attacks by the militant group MEND on oil facilities ("Nigeria's Mend militants claim oil pipeline attack," 2010) and against police forces ("Nigerian 'Mend' militants claim Niger Delta ambush," 2013) resumed. Furthermore, the resources may be controlled by groups aiming to individually benefit from cooperation with foreign investor and letting little for public good (Yelpaala, 2010), thus creating new inequalities (Rothgeb, 1991) and a ground for a social conflict.

b) Determinants of Foreign Direct Investment inflows

Before looking in the reasons for an entrepreneur to invest in a post-conflict country, we should look into how investors generally decide where to invest.

The most common determinants of FDI inflows include such macroeconomic characteristics as size of the local market (Campos & Kinoshita, 2003),'gross domestic product, GDP per capita or population' (Gorbunova, Infante, & Smirnova, 2012, p. 132), level of inflation and unemployment (Özkan-Günay, 2011) or economic performance mostly measured by economic growth (Ho & Rashid, 2011). Indicators of better economic performance usually relate to higher attractiveness for investment. Advantageous location of a country or its infrastructure may also attract investors, because such features may help to decrease costs of production for an investor (Castiglione, Gorbunova, Infante, & Smirnova, 2012). However, while for some countries such indicators as high inflation may determine reluctance of investors to enter their economy, the same indicator may not be decisive for such developed countries as EU members (Özkan-Günay, 2011).

The differences of FDI inflows into the countries with same levels of economic development may be explained through such additional characteristics influencing effectiveness of production as cost and intensity of energy, level of innovations and technology, human capital (Özkan-Günay, 2011; Thangavelu, Yong, & Chongvilaivan, 2009) or cost of labor (Gorbunova et al., 2012). Economic policies on taxation or trade openness are also among the determinants of inward FDI (Derado, 2013; Sharma & Bandara, 2010) as they might effect costs of production and of trade.

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phenomenon was the Netherlands when its exchange rate rose due to high gas exports what led to decrease of Dutch exports (Algieri, 2011)

Another determinant of FDI is found to be 'absorptive capacity' of the recipient economy, what relates to the 'human capital resource, absorptive capacity of domestic firm, financial systems, physical infrastructure, technological and institutional development' (Nguyen, Duysters, Patterson, & Sander, 2009). Among domestic institutions investment legislation, regulations on employment or business registration (Gorbunova et al., 2012) are found to influence investors' preferences.

Political regime as well may impact FDI inflows, however the dimension of such impact is not clear: while some argue that democracy is positively related to FDI (Jensen, 2003) others show just the opposite relation when the rule of law is controlled for (Li & Resnick, 2003). Still alternative explanations argue that in countries exporting natural resources democracy negatively increases FDI, while in countries with low resource exports democracy tends to foster FDI (Asiedu & Lien, 2011).

c. Determinants of FDI inflows to Post-Conflict Countries

Entrance in a post-conflict economy may bring higher profits than entrance in a developed country, as an investor may be the first-comer to the post-conflict market (Williams, 2009) and thus such investor would enjoy monopoly-like position in the domestic market. Cheap prices on labor and commodities add to the attractiveness of such economy. However, post-conflict countries also pose to investors multiple risks including risk of renewing violence, political instability, lack of infrastructure, corruption and regulation problems (Bray, 2009, p. 5).

Even in comparison to other developing countries post-conflict countries have different patterns determining FDI inflow. For example, the level of political risk, the market size and effectiveness of institutions are more important for investors in post-conflict countries than in developing countries in general (The World Bank, 2011a) as political instability in such countries creates higher risks comparatively to regular developing countries, and thus prospects of profits dependent on market size of such risky countries should be higher than in other settings.

Political stability also links domestic institutions, policies or laws to the FDI inflows as such domestic factors may prevent conflicts and thus make a country more attractive to FDI (Appel & Loyle, 2012). Among other risk indicators investors might look into the presence of foreign aid in the countries (Garriga & Phillips, 2013), countries' membership in PTAs (preferential trade agreements) (Büthe & Milner, 2008)

or into such domestic institutions as post-conflict justice institutions as their reputation and cost makes state's signals reliable (Appel & Loyle, 2012).

In contrast, macro-economic characteristics and presence of qualified labor was of lesser concern for investors in conflict-affected countries (The World Bank, 2011a). However, the main concern for such investors is the possibility of 'governmental intervention' (The World Bank, 2011a).

Moreover, according to the World Bank about 70% of FDI coming to conflict-affected countries was concentrated in the resource rich countries (The World Bank, 2011a), what shows that natural resources act as an important determinant of FDI in such regions. However, resource-based FDI may act differently from FDI in other sectors in a post-conflict country An example from post-conflict Iraq shows that while 'lack of security, instability and corruption' tend to impede entrance of FDI in a post-conflict country, resource investors such as oil companies may not see security as 'the major factor' and do not necessarily see violence as an obstacle for their operations (Hanna et al., 2014).

An additional determinant of FDI may be privatization policies, as some post-conflict countries such as Croatia or Mozambique initiate privatization programs to become more attractive to foreign investors (The World Bank, 2011a). However, the net effect of such policies is not clear.

d) Effects of Foreign Direct Investment

FDI has resources larger than local firms and can bring technological and international marketing know-how (Bray, 2010, p. 3). They also can contribute to local infrastructure such as transport or communication due to their work or due to their need for such facilities or by agreement with state (Bray, 2010, p. 3).

One of the main arguments for FDI on the recipient country relates to positive effect of FDI on the economic growth (Campos & Kinoshita, 2002). However, the effect is more significant for countries with 'well-developed financial markets' (Alfaro, Chanda, Kalemli-Özcan, & Sayek, 2004; Azman-Saini, Law, & Ahmad, 2010), while it becomes even negative in post-communist settings (Curwin & Mahutga, 2014).

Such difference in effects of FDI on growth may also depend on the characteristics of FDI, of the recipient state and its policies (Trakman, 2009, p. 5).

Sector-based explanations are widely useful in this regard. For example, while primary sector FDI have negative effect on growth, FDI in manufacturing positively effects economic growth while service sector FDI has ambiguous effects (Alfaro, 2003). Another welfare measure – food security is also found to be negatively affected by FDI in resource sector, while FDI in manufacturing has positive effect on it (Mihalache-O'keef & Li, 2011). Moreover, primary FDI may also be responsible for crowding out investment inflows into other sectors (Poelhekke & Van der Ploeg, 2010).

Effects of FDI on domestic private investment are also ambiguous. Some find that FDI can 'crowd in' private investment (Rath & Bal, 2014), in contrast, other findings show that FDI may actually crowd out domestic FDI in the short run, while increasing efficiency of domestic firms in the long run through spillovers (Fedderke & Romm, 2006, p. 758).

FDI induced technology spillovers can lead to increased productivity of the local firms (Blomstrom & Sjoholm, 1998), substituting for the similar effect of investment in the Research and Development (R&D) (Chuang & Lin, 1999, p. 133). Such effect may be of particular importance for post-conflict countries as they usually lack the resources to invest in R&D; however, transfer of technologies to the domestic sector in some cases may be restricted by their 'absorptive capacity' (Barrios, Dimelis, Louri, & Strobl, 2002; Chudnovsky, López, & Rossi, 2008). Moreover, the scope and direction of the spillovers may also vary between industries (Suyanto, Bloch, & Salim, 2012).

Such spillovers are believed to occur through linkages established between the foreign investor and private sector. However, while manufacturing FDI have a higher potential for linkages (UNCTAD, 2001), primary FDI investments may not bring linkages with local economy to induce technology transfers (UNCTAD, 2001; Yelpaala, 2010, p. 43).

Economic effects and spillovers of FDI also depend on the business model of a foreign enterprise. Investors interested in reaching local markets and in avoiding transportation/tariff costs use horizontal model of FDI replicating own company in a host country (Campos & Kinoshita, 2003, p. 5), this type is also called 'market-seeking'. Such horizontal FDI are mostly used for investments in manufacturing sectors. This model is seen as the most beneficial for host-countries as such enterprises bring the whole production process in a country thus providing know-how to local workers while

at the same time they create linkages with local markets obtaining inputs from local firms (Afriyie, 2009, p. 77).

In contrast investors willing to benefit from regional difference between countries' endowments and policies establish branches of own enterprise in such a way that each branch represents only one stage in overall production cycle thus establishing vertical MNEs showing 'resource seeking' or 'asset seeking' behavior (Campos & Kinoshita, 2003, p. 5). Resource seeking investors may be interested in extraction of natural resources without further processing of the resources at the same country (Yelpaala, 2010). Asset seeking investors in turn would establish production lines in countries with cheap labor, conduct design and research in countries with larger capital endowments and better educated labor, while they would prefer tax havens for final stages of their operations to avoid taxes on commercial transactions without establishing production sites on the territory of the recipient country (Yelpaala, 2010). In most cases of vertical FDI minimum positive spillovers are provided to the host-country because value creation is dispersed between different countries and the host country can learn little from the production stage implemented on its territory (Afriyie, 2009, p. 78). In fact, resource FDI, on the contrary, often inflict negative social and environmental effects on the local population as it happened in Ghana where gold mining activities led to local population's loss of farmlands, water pollution and clashes between the local youth and company's security personnel (Afriyie, 2009, p. 81).

Political effects of FDI are also not clear. According to some authors FDI promote democracy only in the short run and this effects decreases with time (Li & Reuveny, 2003). According to others while FDI from developed democratic countries tend to promote democracy especially if it is in the manufacturing sector, FDI into the mining sector made by developing countries is found to have the most negative effect on democracy (Sun, 2014).

In addition environmental arguments state that FDI can increase or decrease environmental risks in a recipient country. The increase of risks can be linked to low regulation of pollution in developing countries and investors' use of such regulatory flaws, while on the other hand tougher environmental regulations within MNCs and international norms for exports may improve standards of recipient country. FDI in

‘pollution intensive industries’ is found to increase overall level of carbon dioxide emissions (Blanco, Gonzalez, & Ruiz, 2013).

e) Effects of FDI on Conflict and Post-Conflict Countries – Evidence from Literature

A number of studies suggest that FDI is likely to help to consolidate peace. Some proponents of this approach argue that investment, as a factor of economic interdependence and globalization, brings economic development, promotes democracy and thus reduces conflict (Gissinger & Gleditsch, 1999, p. 329). Another explanation is based on the argument that increases in price of foreign capital are positively related to the probability of civil conflict (Chapman & Reinhardt, 2013). Thus, supporting this explanation this approach states that scarcity of capital may cause conflicts and claim that increase of foreign capital can actually decrease the probability of political unrest (Rothgeb, 1991, p. 18)

In contrast other scholars argue that globalization measured as FDI inflows tend to increase inequalities within societies and thus trigger domestic conflicts (Gissinger & Gleditsch, 1999, pp. 335-336) . Such increase of social inequalities may happen if FDI is benefiting only a small portion of population – this effect is strongest in FDI in natural resource extraction (Mahler, 1981, p. 290). The economic value such FDI creates can easily be captured by the government with minimal spill-over to the region in which these investments are located. Similarly, such natural resources investment needs little support from the society of the region as human capital (e.g. engineers) and infrastructure (e.g. excavation machines) can easily be transferred in and out of the region. In addition, the workers in such industries are usually low-skilled – and their interaction with the local populace can be limited (e.g. miners are often live in factory barracks. For instance, in Niger a mining town Arlit was initially created just as a settlement for miners working in the uranium mines operated by AREVA Group ("Niger: Residents of Uranium Mining Town Fear They Are Being Exposed to Radioactive Poisoning," 2005)). In contrast, investments in non-resource sectors, (e.g. manufacture, services, infrastructure) draw a lot of support from this immediate locality: such companies invest in the regions human resources; educate prospective workers in tasks, allowing workers to specialize. Moreover, they claim that state may absorb the economic benefit from growth induced by foreign capital to increase own coercive capacity (Jackson, Russett, Snidal, & Sylvan, 1978, p. 652) and support foreign capital

to guarantee such growth at the same time decreasing own legitimacy vis-a-vis population (Rothgeb, 1991, p. 13).

Another risk is that FDI always creates winners and losers, hence and conflicts of how such losers should be compensated (Bray, 2010, p. 3). New conflicts can emerge due to creation of new sharp inequalities between local elites supporting and supported by foreign investors and poor population dominated by foreign corporations (mainly in manufacturing sector) and decrease of legitimacy of political elites due to their dependence on FDI (Rothgeb, 1991). FDI can also lead to a political reaction from local business as new capital puts old entrepreneurs in a previously capital scarce society in a disadvantageous position – however, this is hardly a case of impoverished societies with very weak or almost absent local capital (Rothgeb, 1991, pp. 15-16). On the other hand improving conditions of local labor can lead to increase of their political demands and if such demands are not met a conflict may arise.

Rothgeb (1991), testing which of these propositions holds, found only that FDI could increase political protests in wealthier countries, while it is mainly negatively related to political turmoil and not related to civil war (Rothgeb, 1991, p. 26). In contrast in a similar quantitative analysis Gissinger and Gleditsch (1999) found that FDI indeed led to higher inequality and higher political unrest though the relation was not statistically significant (Gissinger & Gleditsch, 1999, pp. 345-346). A support for the argument of destabilizing effect of foreign investment is shown in a case-study on post-2003 Iraq stating that FDI 'reinforced destabilizing dynamics' by deepening inequality, decentralization and challenging 'internal and external balances of power' (Castiglione et al., 2012).

Another approach states that private investment is likely to exacerbate conflict due to creation of additional sources for tax-extraction for both government and rebels (Berman, Felter, Kapstein, & Troland, 2012). The authors constructed a information based formal model showing that government and the rebels contest tax revenues from firms and thus violence tends to increase in the short run, however, their empirical analysis shows that in the long run level of violence decreases (Berman et al., 2012, p. 28). The study acknowledges possible opportunity costs and social costs that the rebels can face in response to their violence, and underlines that it is the government whose

greed is crucial for increase in violence to ensure control in the contested regions (Berman et al., 2012).

Though findings of Berman and al. (2012) provide an alternative model for the effect of investment on intra-state conflicts, this model is not fully applicable for our paper as on the one hand effects and characteristics of FDI are different from those of the private investments in general. On the other hand effect of investments during post-conflict period may be also different from that of during the conflict stage. First of all, some foreign investors may have opportunities to leave the country in case of increasing violence (though such opportunity depends on the type of investment, as capital intensive investments such as factories etc. may be more difficult or impossible to move out of the region) while the local entrepreneurs do not have such flexibility. Such exits from the local markets by FDI we can observe quite often, as it was in case of Shell which stopped oil investigation program in the East of Turkey for six years after an attack by PKK in 1992 ("Batman'da Petrol Sahasına Silahlı Saldırı: 3 Ölü," 2011).[3] Thus the greed mechanism may be less applicable for FDI where greedy actors may lose perspective of revenues due to investors exit after conflict recurrence.

Furthermore, the governmental greed emphasized in the model may not be observable in post-conflict settings as some governments on the contrary provide exceptional tax exemptions and subsidies for investors in the conflict affected areas. Turkish policy regarding regional, large-scale or strategic investments (both foreign and domestic) in the conflict-affected Eastern regions, exemplify this approach. Since 2012 such investors enjoy tax reductions larger than that in other regions, receive income tax withholding allowance and support for social security premium not available in other regions (Investment Support and Promotion Agency, n.d.). While we acknowledge that, especially in cases of FDI in primary resource, FDI-related revenues may be a source of greed of governments or rebels, the greed-based models may not be applicable to explain effects of foreign investments on the post-conflict settings.

Arguing that the quantitative analysis accounting for macro-level differences may not explain the variations in possible effects of FDI on internal conflicts Campbell

[3] Apart from the type of investment the size and the expected profits from the investment may also determine the willingness of an investor to exit the country. Big investors with high stakes in the region may prefer not to exit the area or not to stop the operations completely, but just to decrease the volumes of production. For example, in Nigeria oil production was reduced by 25-40 % due to rebel attacks on oil installations ("Nigeria's Oil Production Down 40% Because of Militant Attacks," 2008; "Nigeria Oil Unrest 'Kills 1,000'," 2009). Thus, we acknowledge, that in cases of such investments the possibility of greed-based explanations should also be accounted for.

conducted a micro-level analysis of Columbia and presented a model for FDI effects (Campbell & Carment, N.D.). She argues that a foreign company can influence peace both positively and negatively, depending on the type of conflict (type, stage, and location) and ability of the company to identify and address the type and issues of the conflict correctly, to construct relations according to the type of the enterprise and actors from different parts of society (Campbell & Carment, N.D., p. 37).

Though this study provides a detailed guide for investors on how to operate in a post-conflict environment, the study does not show under what conditions an investor is willing and ready to spend effort to establish such relations. Moreover, such recommendations do not take into account the dynamism of the relations between the conflicting parties and thus the possibility of shifts of balance between them and shift of their preferences. In order to address these issues this paper will firstly present a model of interaction between investors, rebels and state will derive some hypotheses based on such model. The subsequent game theoretical analyses will formally explicate the causal relations these hypotheses present.

CHAPTER 3

THEORETICAL MODEL OF INTERACTION BETWEEN INVESTOR, GOVERNMENT AND REBELS

The theoretic model presented in this paper is based on a population-centric approach arguing that the relations between government and rebel group are dependent on the level of support provided to them by the local population[4] (Siguera & Sekeris, 2012).

A theoretic interaction presented by De Lombaerde and Garay (2010) stipulates that a double-sided relation exists between FDI, economic growth and conflict (De Lombaerde & Garay, 2010). According to the authors on the one hand conflict may increase the volume of FDI inflows and in a reverse way of FDI inflows may influence conflict, on the other hand FDI can contribute to economic growth while higher economic growth may attract more FDI, and at the same time such economic growth (that might be affected by FDI) is also related to conflict as lows growth tends to increase the likelihood of conflict and vice versa, while conflicts are likely to decrease economic growth (and thus affect FDI) (De Lombaerde & Garay, 2010). The graphic presentation of such relation is given below:

[4] Though not all types of rebels might be dependent strongly on the support of local population, still in most cases rebel organizations may be influenced by intelligence information provided by local population to the government. We also acknowledge that the term 'local population' in real life may actually refer t ohighly heterogeneous society at least part of which in fact does not support either government or rebels. Thus a local society with broad part of such neutral population may not influence the relations between the rebels and the government as strongly as this model predicts.

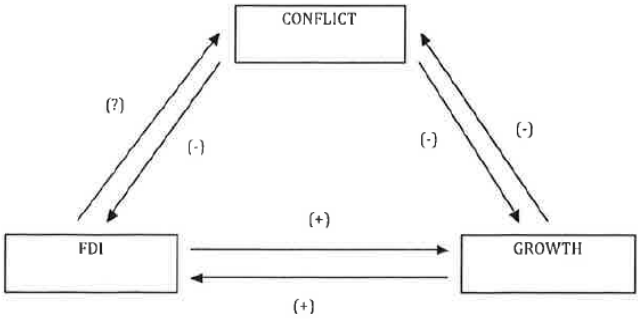

Figure 1: Interaction between FDI, economic growth and conflict. Source: De Lombaerde and Garay 2010.

The nature of interaction between FDI and growth, growth and conflict and the effect of conflict on FDI are widely studied as was shown in the literature review above. In contrast the direction of the effect of FDI on conflict remains unknown. Keeping in mind this complex interaction we will go one step further and analyze the unknown part of the model – the dimension of the impact of FDI on conflict. Adopting a population-oriented approach we argue that FDI influences the relationship between government and rebels in several ways presented below.

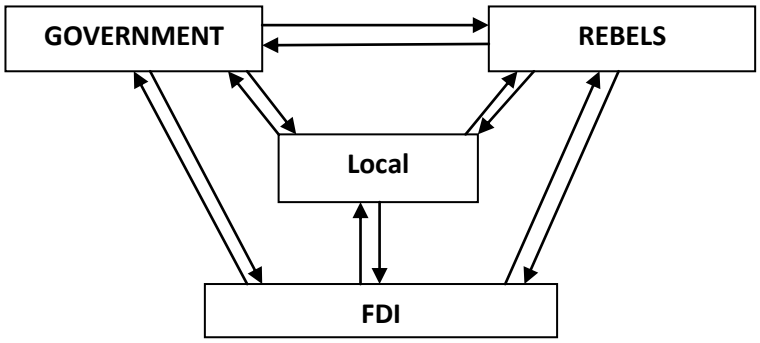

Figure 2: Population-centric view of Government-Rebels-FDI interaction

The goal of this model is to define what the nature of the government – rebel interaction would be: attack or compliance *with the initial settlement.* The interaction depicted on the image can be explained as follows.

First, FDI inflows provide additional revenues for government through taxes, royalties and shares of profit (McMillan & Waxman, 2007, p. 10).[5] Moreover, as before

[5] Share of profits is a common practice in FDI focusing on natural resource extraction though the rates of such schemes differ across countries and time (McMillan & Waxman, 2007). Sometimes they are determined by the

entering a country investors evaluate the market risks analyzing previous developments there, presense of investor in a country disincentivize government from initiating new violent conflict, as such conflict may lead to capital flight from the country, to the loss of expected of FDI-related revenues and damage of the country image as an investment destination. At the same time, governmental policies, such as lowering or increasing bareers for foreign investors' entry, or special policies regarding allocation of the permissions for FDI, influence the amount of investors entering the country and their strategies of entrance and operations. Some of such pro-investment policies, hovewer, may also inflict costs on government. Thus once such policies are implemented the government may have incentives to keep peace and secure presence of FDI in the region.

Based on this interaction we make following proposition:

I. FDI is likely to create incentives for government to keep peace due to prospect of receiving FDI-related revenues which can whither away in case of conflict recurrence.

On the other hand, in some cases foreign investors can also directly cooperate with rebels, seeking rebel support in case of fights between several militias or in order to prevent attacks from the local armed groups (though such activities are deemed as illegal and are scandalized if disclosed). An example for such behavior of foreign investors is a case of South African mining company Anglogold Ashanti who was involved in a scandal of making payment to FDI rebels of Democratic Republic of Congo (Games, 2011). At the same time, rebels can be involved in the violence against a foreign investment in order to take over the resources or take a share of the profits of the company as it is sometimes the case in Nigerian oil rich Niger Delta. However, we do not account for this relation in our model as in the case of illegal interaction between an investor and the rebels, the possible damage for the investor's international image and possible sanctions on such multi-national enterprise would prevent endurance of such relation. At the same time the direct attacks on firms of foreign investors are likely to stop production or motivate investors to withdraw from the country and thus reduce possible spoils. An argument can be made that, even if a foreign mining company leaves the country, the rebels will have access to the natural resources; however, in this

governmental share in a joint-stock company founded between investor and government. Royalties in turn refer to investors' payments to the country for the right to use particular resources or lands of the country.

case models explaining impact of natural resources on conflict may be more applicable than the models explaining impact of FDI.

An alternative relation bewteen FDI and conflict (between government and rebels) relates to the interaction between the three mentioned actors and the local population.

Government – Population Interaction

The interaction between the government and population is based on the notion of legitimacy. A legitimacy can be defined as a consent of people to the right of a state to rule over them (Mcloughin, 2014) and is dependent on the 'output side' of the state – on the quality of public policies and administration (Rothstein, 2007, p. 39), input side – the mechanisms of policy formation, charismatic characteristics of leaders and international recognition (Kurtenbach, 2009). For the purpose of this paper we will focus, however, only on the output dimension of legitimacy assuming other dimensions as remaining constant. In other words, we will focus on the mechanism where the state provides services (i.e. security, health, infrastructure etc.) for the population; the population, in turn, accepts legitimacy of the rule of the state. Moreover, as in post-conflict settings legitimacy may be fragmented and contested by different actors having different forms of legitimacy (Kurtenbach, 2009, p. 8), decrease of legitimacy of the state would mean increase of legitimacy of alternative actors.

FDI can affect the population-government relations in several ways. While social benefits of private enterprises can increase population's support for peace and existing regime (Bray, 2009, p. 2), dependence of government on foreign investment and government's abuse of related economic benefits on the contrary can reduce government's legitimacy (Rothgeb, 1991, p. 3). Indeed perception of unjust redistribution of economic benefits from investments in a particular area is often one of the causes of intra-state conflicts as can be exemplified by Tuareg rebellion in Niger in 2007-2009 when Tuareg demanded from government more equitable redistribution of profits from the uranium mining activities carried out in the region by foreign multinational companies ("NIGER: New Tuareg Rebel Group Speaks Out," 2007). In other words, an equitable redistribution and/or investment of FDI benefits in the region through developmental or other programs tend to increase the legitimacy of the government, and allow the government to garner broader support from the local

population[6]. Conversely, appropriation of all of profits by the central government with little redistribution (or government-led developmental policies) to the affected area is likely to decrease government's legitimacy in that area. Iraqi case provides an example for such FDI relationship where failure of the government to reduce unemployment despite large revenues from oil extraction activities conducted by foreign investors led to expansion of informal economy and 'undermined state legitimacy' (Costantini, 2013, p. 272).

The positive impact of government-led developmental programs on attitudes of the affected population towards the government is supported by an experimental study in Afghanistan conducted by Beath et al (2011). The authors found that program affected villagers' attitudes towards the government indeed improved; however, the authors did not found relation between such programs and security conditions at those areas (Beath, Christia, & Enikolopov, 2011, p. 4). Based on these findings it is possible to propose that if the government will use some or all profits from FDI for a developmental program of the affected region, the legitimacy of the government in those regions will increase.

Population's support for existing order and peace, however, may also decrease if local enterprises are harmed by the FDI as has been the concern in Iraq and Afghanistan (Bray, 2009, p. 15). In other cases, though, local businesses can benefit from the trade linkages with the foreign investor. At the same time too much involvement in politics by the investors may also undermine government' legitimacy (Bray, 2010, p. 21) and create perception of a 'state capture'[7].

Rebels – Population interaction:

When a government fails to provide order and social services for its citizens, a rebel group acting on behalf of these citizens may evolve to be the legitimate representative of their interests. In such a way while a rebel group offers population

[6] This therizing is built on the assumption that the local population have the information about the size of the FDI related profits the government receives and about the way these profits are redistributed. However, it is necessary to acknowledge that in many post-conflict countries lack of transparency of the governments may indeed prevent local population from knowing details of such redistribution. Thus while in cases of large scale foreign investments such as natural-resources FDI, the local population can at least speculatively estimate the amout of profits the government receives and relate it to the scope of services provided by the government, in other cases evaluation of the relation between FDI-related revenues and governmental redistribution may be much more difficult. For the current model we assume that the local population have such knowledge; hovewer, we acknowledge that the lack of population's access to such information can disturb the proposed interactions.

[7] 'State capture' is understood as a situation when a particular group ceases control over state institutions and their decisions (Pesic, 2007, p. 1)

protection of their unmet needs, the population in return accepts legitimacy of the rebel organization and provides some level of support to them.

In regards of FDI as it was stated above the state's legitimacy and local support may depend on the ability and willingness of state to equitable redistribute the benefits from FDI to the local population. Thus if and when a state fails to do so its legitimacy decreases, and if no alternative actor except of rebels is present, the population is likely to provide support for the rebels. In contrast if a state successfully redistributes the benefits and stimulates development of the region, legitimacy of the state is likely to strengthen and support of the state by population is likely to increase. Thus depending on the type of governmental redistributive policies of FDI induced profits, the level of legitimacy of both state and rebels is likely to change in opposite directions.

Based on this relation between the level of legitimacy of (and thus support of local population towards) the government and the redistributive policy of the government, one can theorize that the government has incentive to use FDI profits in order to increase own legitimacy (i.e. decrease local support for the rebels). Though no empirical work up to date has show this exact relation with regards to governmental revenues from FDI, the fact of use of developmental programs and social services as a tool to fight rebels is supported by both academic and anecdotal evidence.

Provision of social services as a tool to increase population's support to incumbent and to undermine local support to the rebels is used for more than half a century. Such policy known as winning 'hearts and minds' through providing services for the populations in the contested areas was made popular and implemented by the British High Commissioner in Malaya General Sir Gerald Templer, who was a part of British colonial administration fighting MCP insurgency in Malaya in 1950s (Stubbs, 2008). Thus our second assumption is regarding the legitimacy inducing potential of FDI:

II. The government has an incentive to redistribute FDI-related revenues in the contested region via public investment, social services or developmental programs in order to increase own legitimacy.

Although use of such policy is often proposed for post-conflict countries in order to promote state-building there, the effect of such programs on the post conflict peace may actually be negative. Change of the legitimacy of one of the parties of the conflict

will change the balance of power between the parties of the conflict and, therefore, induce the reliable commitment problem. Knowing that FDI-related revenue redistribution policy will increase governmental legitimacy and reduce local population's support to the rebels, the rebels can expect that government may try to eliminate them after such goal is achieved. Therefore, unless the government may reliably commit to the initial settlement, the rebels, knowing that their bargaining power (and, hence, fighting capacity as it is also dependant on the local population's support) will decrease in the future, have incentive to break the truce before such program is implemented.

Possibility of such adverse effect of redistributive/developmental programs on peace is supported by the existing literature. A recent empirical study of a state-led development program in Philippines found that such programs correlate positively with the number of casualties in the affected regions (and with increase of violence during civil conflict 'at least in the short term') (Crost, Felter, & Johnston, 2014). The authors explained this finding as linked either to additional sources for greed of rebels or a shift of legitimacy of government that caused commitment problems (Crost et al., 2014, p. 20). Moreover, they found that the violence in Philippines was highest during the preparation stage of the programs (Crost et al., 2014, p. 21) what is consistent with the commitment problem approach as prevention of the programs is likely to prevent change of the balance of power or at least undermine legitimacy of the government acting at the same time as a security providing entity.

Although an earlier study of US-funded developmental program CERP in IRAQ showed that the program tended to reduce violence, the authors acknowledged that such effect was conditional on high strength of troops, small size of projects and high expertise of the people implementing the projects (Berman, Shapiro, & Felter, 2011). At the same time authors stated that non CERP funds accounting for 90% of overall reconstruction spending had no 'violence reducing effects' (Berman et al., 2011, p. 810). Indeed the difference in findings may be explained to occur due to difference of the initiators and funders of the programs: government of Philippines in case of Philippines conflict, and US government in case of Iraqi conflict.

Thus our third proposition regarding the effect of FDI on commitments of rebels is as follows:

III. FDI is likely to create the reliable commitment problem for rebels if government redistributes FDI-related revenues in the regions while it is not able to commit trustfully to the settlement with the rebels (Unless such redistribution of FDI-revenues is the main condition of the settlement).

Interaction between FDI and population:

Foreign owned companies may create multiple positive economic externalities for the local population ranging from employment to education programs, infrastructure building to services, provision of new goods with lower costs, and provision of linkages for local enterprises (Games, 2011). Moreover, as a part of ther corporate social responsibility (CSR) programs foreign companies may directly participate in charity activities or fundraising for the development of societal capacity. Provision of emergency aid by French investor AREVA in Nigerien uranium mine is an example of such programs (AREVA, 2011). On the other hand FDI can also produce such negative externalities harming local population as environmental degradation, work low labor standards, creation of new elites and new inequalities, expropriation of communal lands (as it is the case in many agrigultural investment projects), their security forces may use 'illegal and violent' methods to protect the investor's company or may increase polarization of the society through biased employment strategies etc. (Campbell & Carment, N.D.).

Thus the local population is often directly positively or negatively influenced by foreign business working in a foreign owned company, using goods produced by such company or suffering environmental degradation inflicted by such company. Therefore, in case if such economic externalities are negative population may initiate protests against or attacks on the foreign company. If the government remains unwilling to solve the population grievances, the rebels are likely to initiate attacks against the investor inflicting negative externalities and against government ignoring such negative effect of FDI at least by inaction.

Additional dimension of the relation of population towards investor may also derive from the redistribution of benefits from FDI received by the state. The investor instead of the state can become a 'target of frustration' of people suffering the lack of governmental services which were expected to improve with inflow of FDI (Campbell & Carment, N.D., p. 49). This phenomenon can also relate to the relative deprivation

theory predicting emergence of a conflict when new expectations are not met by new realities (Pruitt & Kim, 2004). Thus, whatever is nature of the frustration of population with the investor, the frustrated part of the local population is going to be represented by the mobilized arm of the population – the rebels.

However, if externalities of investment are positive such as increase of employment, possibility to use new infrastructure or vital services, the population is likely not decrease their support for the rebels in case of their attack on investor or government. Such effect can be explained through opportunity cost argument originally posing that higher employment is likely to reduce rebel violence due to higher opportunity costs for participation in rebel activities (Hanson et al., 2011). Thus positive economic externalities of FDI for the local population are likely to disincentivize rebels from attacking the government. At the same time such externality will not necessarily translate into direct increase of support to the government either, and thus economic externalities of FDI will not change the balance of power and create a threat for rebels. Thus our last proposition is as follows:

IV. Positive economic externalities of FDI are likely to create opportunity cost for local population and, thus, the population's support to rebels may decrease in case if they breach the settlement. However, if the government is the party defying the truce, than the popular support for rebels will not be affected by such opportunity cost. In case of negative economic externalities the direction of the change of population's support for the rebels will be opposite.

To sum up the FDI may produce new incentives for government and rebels to keep peace. At the same time as redistribution of FDI is linked to the State's legitimacy and thus inversely linked to the rebels' legitimacy it also acts as a legitimacy inducing mechanism. Moreover, due to shift in the level of population support of the government or rebels by the local population, during the initial step of peacebuilding the conflict parties are likely to change their commitments made before.

Based on this theoretic structure of the relationship between the government, rebels and Investors we construct a formal model accounting for the conditions necessary to maximize the benefits of such interaction for all three parties.

CHAPTER 4.

THE GAME: STRATEGIC INTERACTION BETWEEN THE GOVERNMENT, THE REBELS AND INVESTOR

4.1. Methodology

In order to understand the strategic interaction between the government, the rebels and investor and the reasons for their choices this paper will construct a game based on the reliable commitment problem. As it was proposed in the previous chapter the interactions between the three actors have a potential of disturbing the initial balance between the government and the rebels and motivate at least one of them to defy on initial settlement. The rationale for the commitment problems as an explanation for intra-state conflict is based on the idea that although conflicting parties may possess perfect information about capabilities of each others, they still may have incentives to fight or 'renegotiate' an agreement (Powell, 2002, p. 24).

Using the rationale of dynamic commitment problem, Fearon (2004) proposed that changing strength of government makes its commitments less trustful and thus prevents settlement of a civil conflict (Fearon, 2004). However, the commitment problem is not limited to government only. A study of international intervention and coercion proposed that coercive demands by a great power may shift balance of power in favor of rebels and thus to create a commitment problem where the rebels can not commit trustfully, and, therefore, governments in such situations are likely to risk international intervention and resort to violent conflict (Haggerty, 2013). The applicability of such logic to the post-conflict settings is also justifiable, as according to Flores and

Nooruddin (2011) commitment or inability to commit is essential for post-conflict peacebuilding as well, because the ex-combatants have no authority ensuring their compliance with the initial agreement (Flores & Nooruddin, 2011).

Therefore, we apply the logic of dynamic commitment problem to the post-conflict settings where parties have information about each other and their balance of power is likely to be shifted in the short run only by entrance of FDI into the country.

4.2. Introduction of the Game: Basic Assumptions

This paper attempts to model government – rebel interaction after formal or informal settlement achieved through negotiations, ceasefire, start of peace process or other peaceful means achieved after a period of mutual violence. The conflict settlement is possible if as a result of the settlement the sides of the conflict receive resources at least equal to their payoffs for the war continuation. We assume that by the time of settlement parties (state and insurgency/rebels) had perfect information acquired through multiple rounds of fights or through other mechanisms. This paper also assumes that the settlement was reached according to the rational preferences with assumption that if states possess perfect information about each other's capacity, they can find an equilibrium, where both states would prefer not to fight, as satisfying demands of an opponent would for both of them provide an outcome better than possible outcome in case of war (Powell, 2002, p. 24).

Thus the first assumption of this model is that parties formally or informally recognize each other, and this mutual recognition was one of the factors that allowed parties to end violence by peaceful means. Due to this reason conflicts, which are ended by complete military victory of either government or insurgency, are not accounted by this model, as they might not provide a context of mutual recognition.

The second assumption is that parties have symmetric information of each other's capabilities acquired through previous fights. Therefore, possible recurrence of war is more likely to occur due to incentives to change the agreed-upon outcomes. Hence this paper will use the dynamic commitment problem approach often used to identify such

incentives of one or both parties to defy peace due to changes in the power balance or in the cost of war (Powell, 2002, p. 24).

Civil war is sometimes seen as a crisis of legitimacy (though this approach is contested by the idea that absence of any alternative power and thus absence of conflict may not mean acceptance of the legitimacy of prevailing incumbent) (Kalyvas, 2006, p. 92). Moreover, the ultimate goal of insurgency can be seen as acquiring such level of support of the population so that government will not be able to sustain own rule any longer (Siqueira and Sekeris 2012). Therefore, legitimacy and rivalry for local support or loyalty are accounted for in this model of domestic conflict. Local loyalty is particularly important for domestic conflicts, as sometimes such loyalty is a determining factor for the success of rebels using non-conventional (paramilitary) warfare tactics (Kalyvas, 2006). Consequently changes in legitimacy (in our case FDI induced changes in legitimacy) in the context of post-conflict country may cause perception of changing balance of power and, thus, may foster defection of the existing agreement in order to prevent future losses due to decreasing bargaining power.

Initial Balance between Parties

The game consists of two actors: government (G) and rebels (R). After the two reach a peace agreement, accounting for the relative power between the parties, an investor enters the disputed territory. We assume that the full control over the fiscal operations such as taxation on this territory remains in the hands of the government. Moreover, regulations regarding investors and the right to allow investment into the area are also in the government's control. This clause is particularly important as in cases where rebels/de-facto autonomous government of the disputed territory controls the policy on investments (Iraqi Kurdistan is an example for this case (Hanna et al., 2014)) presence of investment tends to have rather opposite effects on the parties and their relative balance of power**.**

The actors move sequentially: firstly government decides a policy regarding the revenues accrued from investor and announces or initiates related programs (if any). Then rebels decide to comply with or defy on the initial peace agreement considering the probable outcomes of the policies regarding investors.

Ideally rebels can choose a middle ground between peace and renewal of war by maintaining low scale conflict (Siguera & Sekeris, 2012). In such a way the rebels

signal to the population that they defend interests of the population and thus can increase support of the population in order to move to more decisive actions/war in the next round. For the purpose of this analysis we will assume that such low scale violence may be still seen as a part of negative peace unless any party of the conflict publicly announces an end of a peace process or the conflict becomes overly violent. Such assumption is justifiable as the governments, knowing that recurrence of domestic conflicts may decrease the amount of incoming investments governments have incentives to keep peace and even in case of spot-fighting to assure investors that peace is not endangered (For example, in Democratic Republic of Congo renewal of Katanga militia attacks is said by government not to represent a new wave of war and not to endanger investors in the mining sector of the affected area (Kavanagh, 2013)).

Finally, the government decides whether to comply with or defy on the initial agreement considering the potential reaction of rebels on government policies regarding investment. While making their decisions government and rebels compare different payoffs for different sets of strategies.

We assume that the initial balance between the government and the rebels is perfectly proportional to their bargaining powers (military capacities etc.) and thus to outcomes that could be achieved in case of violent conflict. The balance is defined by the portion of power or resources or control over the contested territory or population (all of these are referred as 'Resources' hereafter) the government has transferred to the rebels in order to satisfy their demands. Thus if we assume that the total of the contested sources is 1, the balance between the parties provides division of such resources as (1-x) kept by the government, and (x) obtained by the rebels. In case of conflict the share of resources the government can acquire is $(1-x)-C_g$, where Cg is the cost of conflict for the government. Similarly, the share of resources that can be obtained by the rebels in case of conflict renewal is $x-C_r$, where C_r is the cost of conflict for the rebels. Moreover, we assume that such equilibrium is stable and there is no initial expectation of any shift in the balance of powers. Thus both parties have no incentives to renew conflict as in case of war their shares of resources/power will decrease in absolute value while comparatively their shares will remain the same.

Entrance of Investor after successful Settlement.

A peace dividend in terms of investment inflow is expected after several years after the conflict settlement. Thus it is expected that some period of relative peace has passed before investors decide to enter the disputed territory.

If government attracts and accepts an investor into the disputed area, the investor is likely to bring new tax revenue or other revenues (denoted hereafter as 'F') from the foreign direct investment (i.e. royalties, rents on licenses, profits from revenue-sharing agreements) and some positive or negative economic externalities (referred as 'Ex' hereafter) for the country (higher employment of local population, technology and knowledge transfer, new services or goods available for the region, commercial linkage between groups etc vs. environmental harm etc.).

Two-Actor Model: FDI without Economic Externalities for Population

Government of a unitary state with no political power sharing with rebels may unilaterally decide what to do with the additional direct revenue from this Investor. Thus Government may redistribute or not redistribute the revenue to the disputed region. In the period 1 the government announces its budget for the year showing, which proportion of the expected revenue will be redistributed to the region (an alternative way to announce the policy regarding the distribution of revenues from FDI may be an announcement of a particular developmental program, public investments etc).

If the government redistributes revenues coming from the new foreign investment in taxes or shared profits, the legitimacy of government in the disputed area will increase by ΔL_g. If the government does not redistribute revenue, the local population will be frustrated and their grievances will increase. These grievances will translate into the higher support to rebels from the population and rise of rebels legitimacy by ΔL_r. In a region with perfectly polarized society (whose support is perfectly divided between the government and the rebels) the change in legitimacy of government inversely related to the change in legitimacy of rebels, thus $|\Delta L_g|=|\Delta L_r|$. For the purpose of this paper we assume that the contested population's support is perfectly divided between the government and the rebels.

In contrast if government engages in redistributes revenues accrued from FDI and invests them in the regions' development, the legitimacy of government is likely to rise by ΔL_g. As a result of rise of government's legitimacy its bargaining power will also rise. Thus rebels can expect that the government will not keep its commitment and will be willing to satisfy less of their demands (i.e. because the government will be willing to keep the share of resources equal to $(1-x)+L_g$ thus decreasing the share of resources granted to rebels. As a result the rebels will be more likely to defy on the agreement before the end of the period and de facto redistribution of resources.

If government does not redistribute revenue coming from the investment (through taxation of the investor or revenue sharing schemes often used for investments in natural resources e.g. Canadian gold mining investor CenterraGold in Kyrgyzstan sharing stocks and revenues from extracted gold (Centerra Gold, 2015)), then the population of the territory where the investor is located is likely to be dissatisfied with government due its appropriation of revenues. Thus this population's support for the government is likely to decrease, as people will perceive such allocation of revenue as unjust, while the population's support for the rebels will increase by ΔL_r. In this case rebels will have no incentive to defy from the initial agreement in the beginning of the period as their bargaining power at the end of this period will increase by ΔL_r.

Due to the expected increase in the rebels' bargaining power at the end of the period, the rebels' initial commitment will become less reliable because with greater legitimacy the rebels may declare higher demands (equal to $x+\Delta L_r$), and if such demands are not met, the rebels are likely to turn to violent conflict in the next periods and acquire a share of resources higher than that initially agreed on. In case of such conflict again the rebels, enjoying population support higher than before, are likely to gain a share of resources higher than that allocated by the initial settlement (the newly demanded share will be $(x+\Delta L_r)$. Niger is an example for such situation where an identity-based conflict between ethnic Tuareg minority and the state settled in 1995 was renewed in 2007 that time with increased number of demands including the call for higher redistribution of revenues from uranium mining located in the Tuareg populated region (Emerson, 2011). Therefore, unless the rebels can ensure their commitments or unless the government is able to increase own bargaining power proportionately, the government is going to be disadvantaged in the long run as its bargaining power will

decrease by ΔL_g. Therefore, the government may prefer to defy on the initial agreement and attack rebels to prevent loss of own legitimacy and of control over the territory.

Besides considering changes in legitimacy and financial benefits from the investor, the government also should take into consideration that in case of renewal of war, investor would be likely to leave the economy or at least stop its operations till the peace is established. Thus in case of war the government will lose its prospect of gaining the revenues (F) from FDI. Furthermore, if the government itself reneges on the agreement, such action will decrease the level of trust that other potential investors have towards this economy by (t), because they perceive the government usually is a guarantor of security of investors while renewal of war puts their investments in danger. As investors come into countries trusting commitment of the government to peace, defection on such commitment will make such guarantees of such government less reliable, while decrease of investors' trust in the long run will mean less FDI inflows and thus less prospects for economic recovery.

In addition both the government and the rebels are going to incur costs of conflict in case if peace is broken (C_g and C_r respectively).

Strategies and Payoffs for the case of investment with no indirect benefits:

The Government starts the game by deciding whether to redistribute FDI revenues or not, and then takes the turn back after receiving a reaction from rebels and if rebels keep up to peace the government decides whether to comply to initial settlement or to defy and restart the conflict. Thus government can use the following strategies: [redistribute, comply], [redistribute, defy], [not redistribute, comply], and [not redistribute – defy] (referred in the figures 1-3 as [R, C] [R, D] [NR,C] [NR,D]).

Rebels act only once in reaction to government's policy regarding the FDI-related revenues and the strategy set of rebels consists of two choices: [comply, defy]. The payoffs for all combinations of strategies used by the parties are given below:

U(G;R): [(Redistribute-Comply), (Comply)] =$((1-x+\Delta L_g)+F; x - \Delta L_r)$

U(G;R) : [(Redistribute-Defy), (Comply)] =$((1-x)-I-C_g; x-C_r)$

U(G; R): [(Redistribute), (Defy)] = $(1-x-C_g; x-C_r)$

U(G;R): [(Not redistribute, Comply), (Comply)] = ((1-x-ΔL_g)+F; x+ΔL_r-C_r)

U(G;R): [(Not redistribute-Defy), (Comply)] = ((1-x)-t-C_g; x-C_r)

U(G;R): [Not redistribute, Defy] = ((1-x) -C_g; x-C_r)

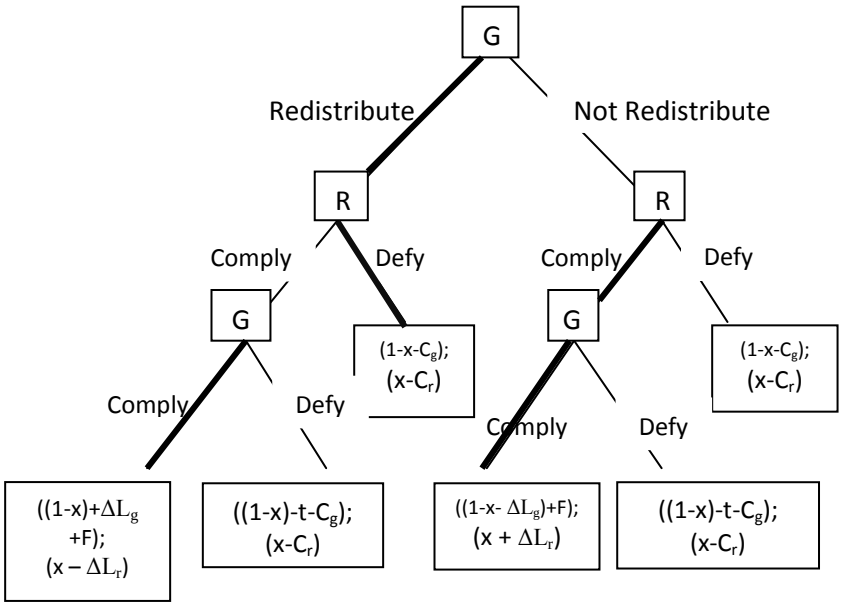

Figure 3 Two-Actor Game without Economic Externalities

If we solve this game by using backward induction, we should start with analyzing government's decisions in two sub-games (sub-games where government redistributes revenue or not). In the sub-game where the government redistributes the FDI-related revenues, the government is likely to choose the 'comply' option as it would increase the payoff for the government to ((1-x+ ΔL_g)+F), as reneging on the truce in such case would bring lower outcomes. If the government does not redistribute revenues, still government is likely to comply if revenues of FDI will compensate to the government the loss of legitimacy at least to such a point that will be more preferable than suffering of costs of conflict and damaged trust – (i.e. if (-ΔL_g+F)>(-t-C_g)). In cases of natural resources FDI in particular anecdotal evidence would be that refenues from FDI indeed are prefered by governments despite the some loss of own legitimacy, thus we assume for the moment that the mentioned condition is satisfied.

Considering that the government is going to keep compliance with the peace agreement, we should identify the strategies that rebels would prefer for each sub-game. If the government decides to redistribute revenue from the spoils of FDI, rebels are going to lose legitimacy if comply with the agreement, and less of their demands will be satisfied at the end of the period. Therefore, rebels would prefer to renege at the beginning to prevent loss of legitimacy. On the other hand if government does not redistribute revenues, legitimacy of rebels would increase and knowing that government is better off when complying rebels would prefer to comply as well and to ask for satisfaction of larger set of demands at the end of the period.

As a result, the government will have to choose from two possible scenarios [redistribute (G) – defy (R)] and [not redistribute (G) – comply (R) – comply (G)]. Once again the decision of the government will depend on the importance the government assigns to the revenues from FDI (and thus in part on the nature of such FDI as governmental revenues from the natural resources FDI tend to be much higher than from other types of foreign investments).

If the government values revenues higher than some loss of legitimacy in the region, (i.e. if $(-\Delta L_g+F)>(-C_g)$) or if the net effect of revenues and loss of legitimacy is still more preferable for government than cost of war, than the initial peace will prevail. And the equilibrium in the game will be established at the scenario [(R)(D)]. An example of such peace may be derived from Nigeria where the government is ready to tolerate grievances of local population for the sake of revenues from oil mining companies providing the main sources of the governmental budget which in turn provides the basis for governmental functioning at all. However, it is necessary to acknowledge that such peace may not be deemed as stable as grievances of the population will continue to increase and the latent conflict will persist. (Latent conflict is a term used to describe a situation where people (or other actors) have differences making them uncomfortable but not to the extent of creating an open dispute unless an external 'triggering event occurs' (Brahm, 2003)). At the same time legitimacy of the rebels will be increasing, so that any exogenous factor may easily spark violent conflict that will result in worse outcome for the government.

However, if the government values revenues from FDI as less important than the increase of own legitimacy in the disputed region, the government is likely to prefer

redistribution of revenues and face possibility of rebels defection. Thus under this condition the equilibrium would be (Redistribute, Defy) scenario. (The mechanism and examples of such scenario will be discussed in the next model as this scenario is likely to occur in case of non-resource FDI which is more likely to bring some economic externalities to the region).

Examination of Redistribution as a Continuous Variable

The model above treated redistribution as a discrete variable which may be either 0 or 1 (0 for not redistribute strategy and 1 for redistribute strategy). However, apparently there is a possibility that redistribution of some portion of FDI related revenues would act consistent with 'not redistribute' strategy, while redistribution of higher proportions of FDI related revenues would result in outcomes similar to those of 'redistribute' strategy. To test this possibility we can solve the following model inspired by the model used by Crost and Johnston (2010) in their discussion paper on developmental projects in conflict settlements (Crost & Johnston, 2010), though the rationale behind the models is different.

First of all we should acknowledge that ΔL_g is a function of redistribution of governmental revenues from FDI (ΔL_g=f(r.F) – change in legitimacy as function of rate (r) that is going to be redistributed out of F). Thus different proportions of redistribution (r can range from 0 to 1) can cause different changes of legitimacy (ΔL_g). The second difference we use of model with continuous redistribution is that we assume that $\Delta L_g = -\Delta L_r$ (in contrast in the model above we used absolute values of such changes). All other variables remain as defined above and the model is solved by backward induction.

Utility functions of peace and conflict for the government are as follows:

$$U_g(\text{peace}) = (1-x) + \Delta L_g + F \quad (1)$$

(ΔL_g can be either positive or negative).

$$U_g(\text{conflict}) = (1-x) - C_g \quad (2)$$

Knowing that the government is the last moving actor in the game we can immediately find a change of legitimacy (based on particular rate of redistribution) that would ensure peace. As the peace is only possible when government values utility of

peace higher or at least equal to than its utility of conflict (i.e. U(peace) ≥ U (conflict)), we can find optimal level of change in legitimacy as follows:

$$(1-x)+ \Delta L_g+F\geq(1-x)-C_g, \quad (3)$$

thus we find the peace inducing ΔL_g to be as follows:

$$\Delta L_g^{*}\geq -F-C_g. \quad (10)$$

This means that the government will prefer peace in any situation, when the change in its legitimacy will incur fewer losses than the loss expected from cost of conflict and withering of FDI revenues. This means that the government can tolerate some amount of negative change of legitimacy and still keep peace (as predicted by the model above). Such condition can be explained as follows: if the change of legitimacy induces suffering of -1 of less (0, +1…) while potential loss of revenue and cost of conflict would induce suffering of -1 or more (-2, -3,…), the government will keep peace. As a result a peace inducing redistribution should support any legitimacy change in range [–F-Cg; +∞)

To find the range of acceptable legitimacy change for rebels we define their utility functions as follows:

$$U_r(\text{peace})=x+ \Delta L_r \quad (11)$$

$$U_r(\text{conflict})=x-C_r \quad (12)$$

Thus the acceptable change of legitimacy for rebels is:

$\Delta L_r\geq -C_r$, meaning that the rebels can tolerate loss of legitimacy until it creates more harm than the losses in case of conflict. Thus the change in rebels legitimacy allowing for peace is as follows-$\Delta L_g\geq -C_r$ or:

$$\Delta L_g\leq C_r. \quad (13)$$

This means that the government can redistribute such a low portion of revenues so that consequent change in governmental legitimacy does not inflict losses on government which are worse than losses in case of conflict, while at the same time such redistribution should not be higher than the proportion which would cause rebels suffering of legitimacy loss exceeding the suffering of costs of conflict. Particularly in

cases, when costs of conflict for rebels approach to 0, the range of redistributed resources will be below the rate that would be satisfactory for rebels.

Knowing that $\Delta L_r = -\Delta L_{r,}$ we can check if there is a minimal level of revenues necessary to sustain such peace. Combining equations of optimal changes of legitimacy for both actors we find:

$$C_r \geq -F - C_g, \quad (14)$$

thus

$$F \geq -C_r - C_g. \quad (15)$$

Meaning that any revenues from FDI (even absence of such) would be enough to sustain peace equilibrium. That is in line with the rationale that change in legitimacy is a function of revenues and redistribution and thus constraint by the revenues. So that absence of revenues would mean absence of change of legitimacy and thus absence of commitment problems.

Two-Actor Model: FDI with Positive or Negative Economic Externalities

This game is based on the same assumptions as the preceding one. The main difference is that this model takes into account that as an investment can have effects other from just revenue for government. Positive externalities of investment may include such benefits for the local population as higher employment, technology and knowledge transfer, new services for the locals (such as road construction), new linkages within the market etc., any initiation of violence will impose opportunity costs for rebels themselves or the people willing to join rebels in case of rebel-initiated conflict. Such effect would not hold for the government initiated conflict as the government has a fixed army which is not affected by the local opportunity costs of the region. The assumption is that entrance of an investor regardless of government's policies on revenues may create immediate externalities (i.e. employment) even before it is possible to observe governmental policies or their effects. Such positive economic externalities by the population would impose additional costs on the rebels going to

defy on the peace agreement, due to the possibility of loss of such externalities in case of conflict relapse.

On the other hand, an investment may not bring any positive externality for local population (if due to lack of sufficient human capital only outsiders work at the investment site, the products are not oriented on local market, local economy is not able to establish linkages etc.), while instead causing negative externalities such as pollution, health problems, confiscation of common lands etc. In this case presence on an investor may cause additional grievance on the part of population as government would benefit from the investment, while locals will be harmed by it. Thus even presence of such investment irrespectively of redistribution policy of government may decrease support of population to the government and increase legitimacy of rebels. As a result such negative economic externalities do not create an additional opportunity cost for rebels, but in opposite increase local support to them in case of rebellion (such support may not be related to legitimacy balance as those joining the cause may join just to fight against the investors and not against the government per se).

Strategies and Payoffs for the case of investment with Positive Externalities:

Strategies available for both parties remain the same, where Rebels can either comply or defy, while the Government may choose out of following actions: [redistribute, not redistribute, comply, defy]. The sequence of actions remains the same: [State – Rebels – State], the only changing feature in this model is that initiation of a war puts an additional cost of economic externalities Ec on the rebels. The cost is higher in cases with higher benefits of the investment for the local society.

The payoffs for the available strategy sets are given below:

U(G;R): [(Redistribute-Comply), (Comply)] =$((1-x+\Delta L_g)+F; x - \Delta L_r)$

U(G;R) : [(Redistribute-Defy), (Comply)] =$((1-x)-t-C_g; x-C_r)$

U(G; R): [(Redistribute), (Defy)] = $(1-x-C_g; x-C_r-Ec)$

U(G;R): [(Not redistribute, Comply), (Comply)] = $((1-x-\Delta L_g)+F; x+\Delta L_r-C_r)$

U(G;R): [(Not redistribute-Defy), (Comply)] = $((1-x)-t-C_g; x-C_r)$

U(G;R): [Not redistribute, Defy] = $((1-x) -C_g; x-C_r)$

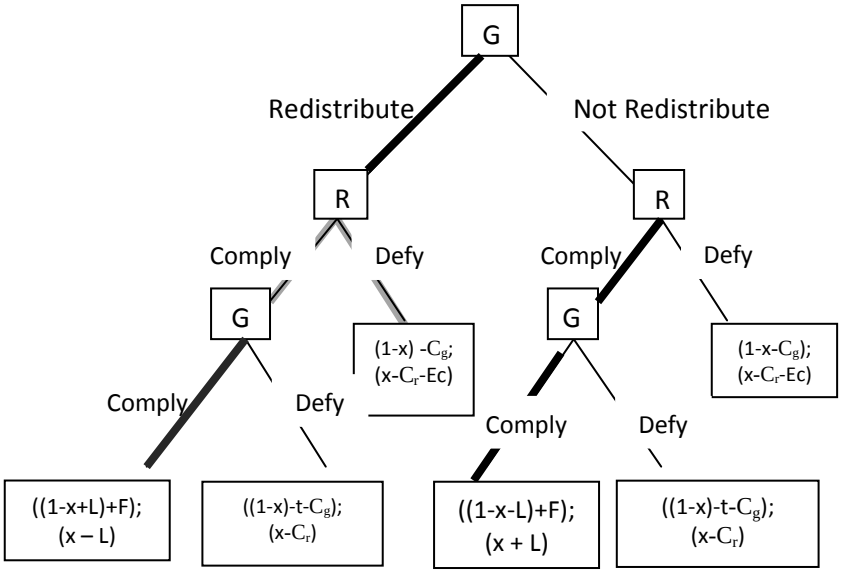

Figure 4: Two-Actor Game with Economic Externalities

Solution via Backward Induction:

When choosing whether to comply or defy in the sub-game 'Redistribute' the government compares possible outcomes or own actions. As outcome of compliancy $((1\text{-}x+\Delta L_g)+F)$ is obviously better than ((1-x)-l-Ec), the government is likely to prefer compliance to defection.

In the sub-game 'Not redistribute' the government choosing between compliance and defection again is likely to comply if government values revenues of FDI higher than it values the related change in legitimacy or at least if revenues of FDI can compensate to the government the loss of legitimacy at least to such a point that will be more preferable than suffering of costs of conflict and damaged trust – (i.e. if $(-\Delta L_g+F)>(-t\text{-}C_g)$). As was mentioned above such choice is expectable if the FDI-related investments are vital for the government as in cases of FDI in natural resources cases. Though if this condition does not hold, the government is expected to renege on the previous agreement and restart conflict.

Rebels also choose between a payoff for defying and complying keeping in mind that the most probable action of government is to comply. Therefore, rebels choose between the outcomes of $(x\text{-}\Delta L_r)$ and $(x\text{-}Ec\text{-}C_r)$ in the sub-game where government redistributes the profit from investment and between $(x+\Delta L_r)$ and $(x\text{-}Ec\text{-}C_r)$ in the sub-game where government does not redistribute the profit. If Ec – economic externalities of the foreign investment is positive, than clearly that in the second sub-game rebels

would prefer to comply. (Case of negative externalities will be examined below). Knowing that rebels would comply in the 'non-redistribute' scenario, we should focus on the 'redistribute scenario' as payoffs for all possible solutions of this scenario for government are higher than payoff for mutual compliance with the agreement in the second sub-game.

Thus the main question is whether the rebels will comply or defy on the peace agreement under the 'redistribute scenario'. The rebels will have to choose between the outcome where their legitimacy will decrease as a result of successful redistribution of profits by the government ($x-\Delta L_r$) and the case where they will face opportunity cost due to elimination of positive externalities of the investment (thus the payoff for defying of rebels in this context is ($x-Ec-C_{r)}$).

Accordingly, considering the additional costs of initiating a conflict in the presence of indirect benefits of the investment for the local population, the rebels will be likely to defy only if cost of elimination of positive externalities of FDI will be lower than the cost of decrease of their legitimacy. Otherwise, the peace will prevail if the costs of elimination of the external benefits of the investment will be even higher than decrease in rebels' legitimacy due to redistribution of the investment revenues by the government.

As a result the government will prefer to redistribute FDI related resources and increase own legitimacy when FDI has a capacity of creating opportunity costs that perceived by the rebels as more important than decrease in their own legitimacy. Such situation may happen when the rebels and the local population may successfully integrate into the peaceful economy and fully benefit from peace. In this case a sustainable peace may be expected with gradual full integration of the society and development in the region together with consolidation of the state[8].

However, in cases where such positive externalities are perceived by rebels as less important than the change in their legitimacy, the rebels are likely to defy (in the sub-game 'redistribute'). Therefore, the government expecting such outcome would be likely to refrain from redistributive policies and prefer the non-redistributive strategy

[8] Kurtenbach (2009) notes statebuilding and peacebuilding sometimes may need contradictory strategies, as successful peacebuilding may need acceptance of 'multiple sovereignties' while state-building focuses on consolidation of unique state sovereignty (Kurtenbach, 2009, p. 8).Therefore, a situation where both goals of sustaining peace and strengthening the governments sovereignty is a rare example of successful post-conflict transformation.

(given that government values F more than ΔL_g). Thus, the second possible equilibrium in this model is [(NR-C) (C)] scenario, where the peace will be kept in the short run, but the latent conflict will persist.

However, if government fails to estimate the rebels preferences between change in legitimacy ΔL_r and opportunity cost Ec, or if the governments the government estimates them right, but values the net effect of decreasing legitimacy and revenue obtained ($-\Delta L_g + F$) as even less desirable than cost of war, than the equilibrium of the model will be the [(R) (D)] scenario where the conflict will recur because both government and rebels will try to maximize own bargaining position and perceiving a threat of defection from the opposite party will prefer immediate conflict.

Though such outcome could be seen as not expectable, the real life examples show that such tensions between the rebels and the government indeed take place during the post-conflict period. A Turkish case of the peace process with PKK insurgency may exemplify the scenario where new governmental (non-military per se) investments are perceived as strategic threat to the rebel group and are often targeted by violent attacks(7, 2015), while at the same time a large amount of private investment has entered the region thus creating opportunity costs for local support to the group (and such investors are rarely targeted by violent attacks). Though in order to claim the particular relations between the preferences of the rebels between the changing legitimacy and new opportunity costs, broad qualitative case study would be required, even based on anecdotal evidence it is possible to say that the legitimacy and opportunity costs of investments of Turkey are pushing the situation in opposite directions. And such contradictory nature of investment-redistribution mechanism may be seen in the persisting sporadic violence neither turning into a renewed conflict nor letting the peace consolidate. As in such case defining of a scope of redistribution (instead of yes-no definition) may be necessary in order to create a policy for sustainable peacebuilding (in order to reach the [(RC),(C)] equilibrium). .

Before examining redistributive policies as a continuous value in order to define such peace-inducing redistribution scope, we will shortly look into the outcome of the same model given that the economic externalities of FDI are negative. Such externalities may create additional strength for the rebels, for example in case if loss of habitats due to negative environmental consequences of FDI, may lead to active

participation in the rebel troops of the people who would otherwise support the rebels in a more passive way (due to lack of any other opportunity, lack of income etc). In this case the model presented above will remain fully the same with only difference that Ec now is a variable negative in sign.

As such scenarios are often peculiar to natural-resources FDI such as oil or uranium mining, gold extraction etc., we assume that the government values revenues F much higher than change in legitimacy ΔL_g. Thus the government will prefer to commit to peace in both sub-games. The rebels in turn will prefer defection in the 'redistribute' sub-game and keeping peace in the 'not redistribute' sub-game. As a result the government will prefer not to redistribute the revenues, thus the sole equilibrium in the model of negative economic externalities of FDI is expected to be [(NR-C), (C)]. Once again though this equilibrium will keep peace in the short run, it will contribute little to the consolidation of state authority over the dispute territory, and more importantly, the latent conflict will persist, thus paving a way for a new conflict with strengthened rebels in the long run.

Examination of Redistribution as a Continuous Variable

Again as ΔL_g is a function of redistribution of governmental revenues from FDI (ΔL_g=f(r.F) – change in legitimacy as function of rate (r) that is going to be redistributed out of F), the possibility of a continuous range of rates of redistribution from 0 to 1, creates a possibility of variations of the size of ΔL_g. The changes in legitimacies of governments and rebels interact as follows: $\Delta L_g = -\Delta L_r$. All other variables remain as defined above in the 'Two-actor game with economic externalities'. This model is also solved by backward induction.

Utility functions of peace and conflict for the government are as follows:

$$U_g(\text{peace}) = (1-x) + \Delta L_g + F \qquad (16)$$

(where ΔL_g can be either positive or negative).

$$U_g(\text{conflict}) = (1-x) - C_g \qquad (17)$$

As the peace is possible when government values utility of peace higher or equal to the utility of conflict (i.e. U(peace) ≥ U (conflict)), the optimal level of change of legitimacy (and thus redistribution) is as follows:

$$\Delta L_g^{*} \geq -F-C_g. \quad (18)$$

This equation means that government will prefer peace in any situation when the change in its legitimacy will incur fewer losses than the loss expected from cost of conflict and withering of FDI revenues. Hence, that the government can tolerate some amount of negative change of legitimacy and still keep peace. As a result a peace inducing redistribution should designed in such a way as to result in legitimacy change in valued by government in range $[-F-Cg; +\infty)$

To find the range of legitimacy change acceptable for rebels we define their utility functions as follows:

$$U_r(\text{peace})=x+\Delta L_r \quad (19)$$

$$U_r(\text{conflict})=x-C_r-Ec. \quad (20)$$

Thus the change of legitimacy for rebels that will allow for their keeping peace is:

$$\Delta L_r^{*} \geq -C_r-Ec, \quad (21)$$

(meaning that decrease in ΔL_r is tolerable till $-C_r-Ec$)

This equation means that the rebels can tolerate loss of legitimacy until it creates more harm than their losses which would occur in case of conflict. If we combine equations (A) and (B) and substitute ΔL_r by ΔL_g from (based on the idea that $\Delta L_r = -\Delta L_r$) we find:

$-\Delta L_g^{*} \geq -C_r-Ec$; or in other terms

$$\Delta L_g^{*} \leq C_r+Ec \quad (22)$$

Thus the change in governmental legitimacy (as a function of redistribution) can be as follows:

$$-F-Cg \leq \Delta L_g^{*} \leq C_r+Ec, \quad (23)$$

and can be represented graphically as given on the Figure below (the figure in blue states for the range of ΔL_g that would induce peace, while white areas account for the ranges of ΔL_g where recurrence of conflict is expected. On the left side the expected defector of peace is the government; on the right side the expected defector of peace are

the rebels. The figure shows that absence of redistribution whatsoever may cause war, while too much redistribution inducing significant change of balance of power can also lead to conflict recurrence.

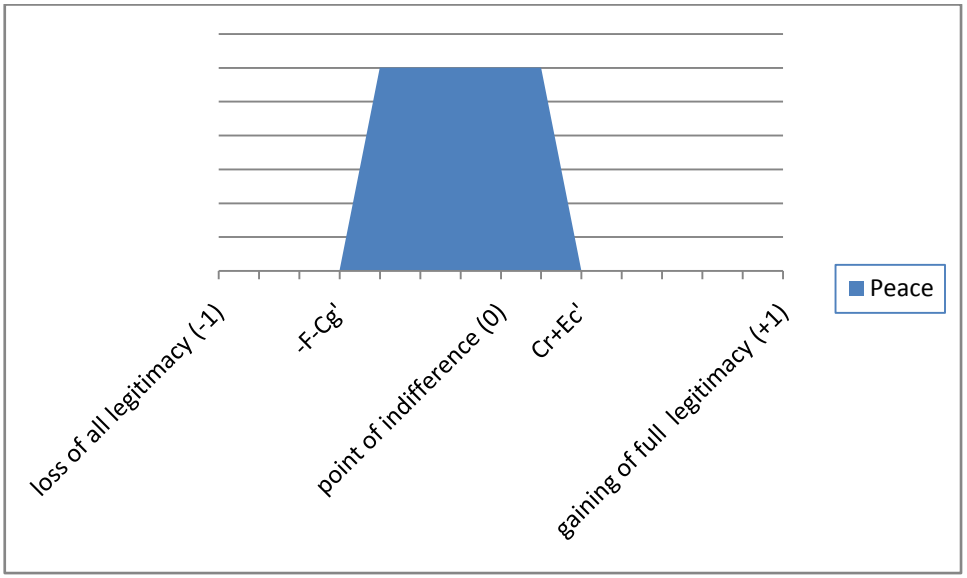

Figure 5: Peace and the Scope of Shift of Legitimacy induced by Redistribution of FDI related revenues

These results predict that the peace may prevail if redistribution of FDI related revenues by the government will be within the defined range. The figure assumes that Ec is positive and, therefore, shows that peace can be sustained even with some increase of government's legitimacy (up to the point that will be valued by the rebels as costlier than the opportunity cost and the cost of conflict). It is necessary to point, however, that if Ec is negative, the most possible outcome is that all the range of peace inducing ΔL_g will follow on the negative side of the graph.

We can also check if there is a minimal level of revenues necessary to sustain such peace. Combining equations of optimal changes of legitimacy for both actors we find:

$C_r+Ec \geq -F-C_g$, thus $F \geq -C_r-C_g-Ec$. While the result seems to show that the amount of governmental revenues of FDI is not important for FDI with positive externalities, the situation is opposite for FDI with negative externalities (when $Ec<0$). In such case if the absolute value of negative externalities exceeds the absolute value of the sum of costs of conflict for the government and the rebels, then the governmental revenue from

FDI should be at least less or equal than the difference between the value of negative externalities and the sum of the costs of conflict.

Three-Actor Model

Now when we have modeled the interaction between the government and the rebels taking place after foreign direct investment enters a disputed area, we examine whether investor can and have incentives to influence the government-rebels interactions. The expanded model presenting this mechanism is presented below.

The model presents three actors, two of which are sides of a currently settled conflict (i.e. the government and the rebels). The remaining one is an external actor (i.e. the foreign investor) entering this local post-conflict scene. The Nigerian government and MEND insurgency in Niger Delta, Turkish Government and PKK, Columbian government and FARC, Nigerien government and Niger Movement for Justice (MNJ) exemplify such conflicting government-rebel group dyads. The oil producing company Shell in the Niger Delta in Nigeria, or uranium extracting French company AREVA in Niger experiencing negative impacts of the conflict between the government and local Tuareg insurgency MNJ exemplify potential third party investors. The investor is assumed to be impartial and acting only in accordance with the rationale of profit maximization for itself.

We assume that the government and rebels have already signed an initial peace agreement which puts the conflict at stage of transition. Hence, we assume a state of (albeit tentative) peace with no immediate pending crisis risking immediate recurrence of violence. The government's aim, therefore, is to consolidate peace *and* to solidify its control over the region at the same time. Towards that end, the government aims to foster economic development in the region. Securing foreign investment in this post-conflict zone constitutes a critical step in attaining such economic development[9], as economic development can reduce poverty and economic grievances of the population and thus reduce risks of war recurrence (Walter 2004). Indeed national governments often spend a lot of effort to attract foreign investors. For instance, the Nigerian government, between 2005 and 2007, visited various Asian countries and conducted a series of meetings to attract local investors there.

[9] See Campos and Kinoshita (2002), Alfaro et al (2004), Azman-Saini, Law, and Ahmad (2010) for the relationship between FDI and economic development

Our game models the interaction between all the three parties, namely the government, the rebel group and the foreign investor. The interaction is shown in the Figure 2. The game starts when the investor, already having decided to enter the post-conflict market, decides what kind and what scope of business activities to pursue (whether to follow vertical or horizontal model of multinational enterprise, whether to engage in one business activity or more) and whether it will also allocate resources as a part of its corporate social responsibility (CSR) programs (such as schools, hospitals, etc.), and if the company decides to do so, to what extent the size of this allocation will be. For instance, in Niger a French mining company AREVA funds two local hospitals providing free care for local community, emergency aid and some educational programs (AREVA, 2011). Investor can either just conduct own economic activities without engagement with local community. However, the type of economic activities pursued by the investor will determine the presence and scope of positive or negative economic externalities inflicted by the investor's operations on the local population. Investor can also engage in social responsibility programs (often contributing to the local peace building programs), or provide some social support or infrastructural development for the local community without necessary need for such infrastructure for the business itself.

Moreover, the foreign direct investment, when operating, creates revenue for the government, such as tax revenue, royalties and/or shared profits from operations. We call this revenue of the government FDI spoils. The government decides whether to redistribute such revenues for the local population or divert these resources for other purposes (e.g. to other regions, for its clientelistic networks, for military purposes etc). The rebel organization, observing the government's action regarding the redistribution of FDI spoils, then decides whether to keep peace or reignite conflict. If the rebels attack, the game ends. If the rebel group decides to keep the peace, the government then decides whether it should honor the initial settlement or defy and try to eliminate rebels.

To sum up the basic interactions and outcome are as follows. The government can redistribute or not redistribute FDI-related profits what will affect the population's support the government enjoys in the disputed territory. The governmental policy thus will change governmental legitimacy in the region by ΔL_g, which will translate in a proportional change in the rebels' legitimacy by ΔL_r, as legitimacies of the rebels and government are mutually exclusive and their sum is equal to 1. The government and the

rebels have initial balance of power represented as a share X of the government's resources provided to the rebels to satisfy their demands, while the government keeps itself 1-X of the resources. Moreover, if conflict recurs both sides will suffer from costs of conflict, where C_g is the cost of conflict for government, and C_r is the cost of conflict for the rebels.

Finally the investment produces opportunity costs for rebels. Such costs are based on positive economic externalities (Ec) of FDI and community's benefits from the corporate social responsibility programs (Sr). The economic externalities (Ec) of FDI may also be negative and incentivize rebels to restart conflict. Investor has a potential to increase or decrease such economic externalities and benefits of social responsibility programs (CSR program inflicts an additional cost on investor (C_{sr})). In order to make such decision investor analyzes prospects of war or peace. If peace prevails investor will earn profit f(I) (where f(I) is a function of the investment I) and pay maintenance cost (C_m). In case of war, however, investor does not receive any profit as business operations are likely to at diminish or stop during the crisis, at the same time investor will still pay maintenance costs C_m and face a possibility of full destruction of the investment capital (machinery, building etc) shown in the model as a(I) – where a is the probability of destruction of the whole investment capital I. The expected payoffs for all this strategies are given in the figure and table below.

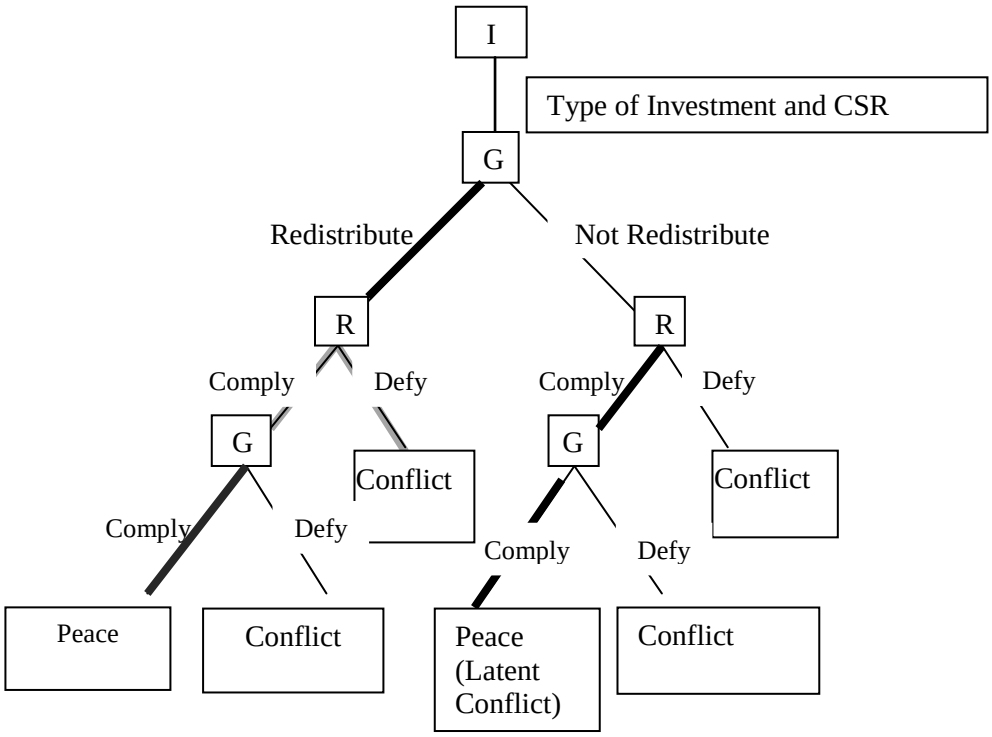

Figure 6: Strategic Interaction between Investors, Rebels and State

(R, C) (C)	(R, C) (D)	(R) (D)	(NR, C) (C)	(NR, D) (C)	(NR) (D)	Investor
$((1-x+\Delta L_g)+F);$ $(x-\Delta L_r)$ $(f(I)-C_m)$	$((1-x)-t-C_g);$ $(x-C_r)$ $(-C_m-a(I))$	$(1-x-C_g);$ $(x-Ec-C_r)$ $(-C_m-a(I))$	$((1-x-\Delta L_g)+F);$ $(x+\Delta L_r)$ $(f(I)-C_m)$	$((1-x)-t-C_g);$ $(x-C_r)$ $(-C_m-a(I))$	$(1-x-C_g);$ $(x-Ec-C_r)$ $(-C_m-a(I))$	No CSR
$((1-x+\Delta L_g)+F);$ $(x-\Delta L_r)$ $(f(I)-C_m-C_{sr})$	$((1-x)-t-Cs-C_g);$ $(x-C_r)$ $(-C_m-a(I)-C_{sr})$	$(1-x-C_g);$ $(x-Ec-S-C_r)$ $(-Cm-a(I)-C_{sr})$	$((1-x-\Delta L_g)+F);$ $(x+\Delta L_r)$ $(f(I)-C_m-C_{sr})$	$((1-x)-t-Sc-C_g);$ $(x-C_r)$ $(-C_m-a(I)-C_{sr})$	$(1-x-C_g);$ $(x-Ec-Sr-C_r)$ $(-C_m-a(I)-C_{sr})$	CSR

Table 1: Payoffs of the Rebels, the Government and Investor in Three-Actor-Game

Solving using the backward induction technique we know that on the latest stage of the 'No CSR-Redistribute' sub-game the Government will definitely prefer to comply with the agreement. In the 'No CSR- Not Redistribute sub-game' the government will

also prefer to comply if the revenues from FDI offset for the government the harm of decreasing legitimacy at least to the extent where such harm will be less costly for the government than costs of war and international investors' trust.

The rebels, in turn, in the 'No CSR - Not Redistribute' sub-game, will prefer to comply (thus sub-game equilibrium for this scenario will be sustenance of peace with latent conflict), while in the 'No CSR - Redistribute' sub-game the decision of rebels will depend on the preference of rebels between ΔL_r (change in rebels' Legitimacy) and Ec (opportunity cost of economic externalities of the FDI) combined with the cost of conflict. The preference in turn depends on the balance between the scope of opportunity costs created by FDI for population and rebels, and on the magnitude of expected decrease in populations' support provided to rebels. If the rebels expect that opportunities provided by the economic externalities of FDI will not be able to offset their loss of legitimacy (and the associated risks of losing some bargaining power) due to rising support of population to the government, then the rebels will prefer to defy on the initial settlement in order to secure initial balance of power. Hence the sub-game equilibrium for 'No CSR-Redistribute' will be the recurrence of conflict due to rebels' defection. The case of negative economic externalities will result in the same outcome.

In contrast, if positive externalities of investments will create opportunity costs exceeding the costs of decreasing legitimacy of the rebels, the rebels will prefer to keep peace and the equilibrium in this sub-game will be the peace with latent-conflict. Thus the government will make the initial decision of redistribution or not redistribution of the FDI-related revenues by analyzing the following conditions:

1) The state's preferences between ΔL_g and F, and the costs of conflict, and:

2) The rebels preferences between ΔL_r and Ec, and costs of conflict (or the preferences of rebels between ΔL_r and Ec combined with Cs and costs of conflict).

In case when government values FDI-related profits higher than the change in legitimacy (or at least makes offsets such change in legitimacy to a point when it is seen by the government as less costly than conflict relapse), and the rebels value change in legitimacy as more important than opportunity costs induced by FDI the expected equilibrium of the (No CSR) sub-game would be [(Not Redistribute-Comply) (Comply)], - prevalence of peace despite persisting latent conflict. In the CSR sub-game

the outcome is the same if opportunity costs created by the CSR program does not increase the total costs of rebels defection to outweigh their harms in case of decrease of their legitimacy by $\Delta L_{r.}$ If, on the contrary, the CSR program does makes the total costs of defection for rebels higher than the cost of decrease of their legitimacy, than the 'CSR' sub-game equilibrium would be [(Redistribute, Comply) (Comply)]. However, irrespectively of the equilibrium in the CSR sub-game, as in short run investor is indifferent between the payoffs of any peace (with or without latent conflict), the investor would not have incentives to engage in costly CSR programs or to increase positive externalities (or decrease negative externalities) of own business. Thus the most expected equilibrium in this game is [(No CSR) (Not Redistribute, Comply) (Comply)].

However, it is necessary to mention that, considering the persistence of latent conflict in this equilibrium, in the long run investor ideally may be better to increase positive economic externalities of own activities and CSR spending to enable government to more to a more sustainable equilibrium of [CSR) (Redistribute, Comply) (Comply)] if such shift is possible. (In fact such shift may be very difficult because as we mentioned above the setting where government prefers FDI-related revenues to legitimacy emerge in a countries with natural resources endowments, as resources extracted by foreign investors often provide the main source for governmental budget. At the same time such investments tend not to produce large positive economic externalities due to their vertical business models[10], or even produce negative externalities such as environmental degradation. As a result, only if the investor is able to conduct large-scale developmental projects significantly benefitting the local society, can such CSR lead (without additional external factors such as aid/internationally funded developmental programs) to a change in the equilibrium to peace without latent conflict. However, even in this case such FDI-funded developmental programs may rise questions on the sovereignty of the state what can endanger the process of state-building.) Alternatively, investor's engagement in CSR may be advisable in order to prevent direct attacks on investor's facilities from the local population or rebels (as we mentioned above sporadic attacks are possible during post-conflict periods even without necessary return to conflict), or due to other motivations not considered in this paper (such as international recognition, increase of efficiency of local operations etc).

[10] The relation between positive spillovers and different models of FDI is discussed on the pp. 12-13.

Nigeria can exemplify such case as the oil production in the Niger delta region with low benefits for the local population and high negative effects including environmental degradation bring a case where economic externalities are even negative, and thus utility of ΔL_r for rebels is definitely higher than utility of Ec. At the same time the high scale oil production in Nigeria providing an important source for Nigerian budget, makes government value FDI-related revenues F as more important than the decrease of its legitimacy in the region. As a result, the government in such conditions follows the strategy of (not redistribute, comply) what brings an uneasy peace in the region with persistent grievances of the population. The CSR program related evidence suggests that although some companies as Areva engage in such activities in Niger, anecdotal evidence suggests that population do not perceive such programs as even offsetting the negative externalities of Areva's operations ("Niger: Residents of Uranium Mining Town Fear They Are Being Exposed to Radioactive Poisoning," 2005), thus such CSR activities do not show a potential of changing current equilibrium.

In contrast, if government perceives change in legitimacy as less important than FDI-related revenues, while rebels perceive opportunity costs of economic externalities of FDI as more important than decrease of own legitimacy, than an equilibrium would be reached at [(No CSR)(Redistribute, Comply) (Comply)] consolidating peace and state's control. However, such settings are highly unlikely as profits making governments to neglect loss in legitimacy are usually coming from natural resources FDI having little positive economic externalities. At the same time such preferences of rebels are possible only if economic externalities are high. Such externalities may be more often (but not necessary) provided by FDI in services, infrastructure or manufacturing (still governmental regulation, development of local human capital and other factors limiting capacity of local community to absorb such positive externalities). Therefore, we leave this equilibrium without broad discussion, as while arithmetically it is possible, the conditions prevailing in the post-conflict countries with existing models of business are not likely to satisfy conditions necessary for such equilibrium.

A different situation emerges when the government perceives negative change in own legitimacy as more harmful than loss of FDI related revenues and costs of renewed conflict. In such case in the 'No CSR' sub-game there are two probable equilibriums. The first is peace, which is expectable if rebels would perceive loss of the positive economic externalities of FDI as more harmful than loss of some legitimacy to the

government (if $Ec > \Delta L_r$). Thus if rebels would estimate $Ec+C_r > \Delta L_r$, then peace will be sustained with the best possible terms for government (providing increase in legitimacy and economic development at the same time). On the other hand if rebels would deem decrease in legitimacy as more harmful than the loss of positive externalities of FDI and suffering costs of conflict, then the rebels are likely to renege on the initial settlement and the conflict will recur (the alternative 'No CSR' sub-game equilibrium). Thus in this case the value of positive externalities of investment is crucial for the balance between peace and conflict as it defines which of the two possible equilibriums will be realized.

The equilibriums are similar in the 'CSR' sub-game with only difference that rebels should compare the values of ΔL_r (change in legitimacy induced by governmental redistribution of FDI-related revenues) and $Ec+C_r+Cs$ (the sum of opportunity costs induced by positive economic externalities of FDI and CSR programs funded by the investor and the cost of conflict). Thus when investor decides in such settings whether to fund a CSR program and whether to follow a business model to maximize economic externalities for the local population, the investor firstly defines whether peace is possible without such costly CSR program. And if not whether a CSR program can increase the total of costs of conflict for rebels to such extent, so that the rebels would prefer peace despite decrease in their legitimacy due to redistributive policies of the government. If even without a CSR program, peace is possible (if rebels value $\Delta L_r < Ec+C_r$), then investor will not have incentive to conduct such program as the best possible outcome will be already at place. (This proposition does not imply that the investor definitely will not or should not initiate in such program – on the contrary additional opportunities provided by CSR would even strengthen such equilibrium, as well as bring the investor other possible benefits (such as international recognition, some tax exemption provided by the government, and other factors not accounted in our model). Thus under such conditions equilibrium will be [(No SCR) (Redistribute, Comply) (Redistribute)].

Similarly, if even with an affordable for investor CSR program peace cannot be sustained (if rebels value $\Delta L_r > Ec+C_r+Cs$ and thus believe that risk of loss of all opportunity costs and of suffering cost of war is less harmful than a threat due to probability that government will renege on its commitments after the end of the period – when governments legitimacy and, hence, bargaining power will increase), the investor

will not have incentive to engage in such program. Such situation may emerge when economic externalities of investment are low due to the character of investment. As a result, equilibrium under such conditions will be [(No SCR) (Redistribute-Comply) (Defy)]. Again, even though SCR programs are not expected to efficiently contribute to peace, they still may be useful for investors in order to reduce the risks of capital destruction in case of conflict recurrence and for other reasons cited earlier.

And only if the rebels value change in legitimacy pretty close to the opportunity costs of conflict and thus the rebels may hesitate between engaging in conflict or sustaining peace, CSR programs initiated by foreign investors will have the largest effect as it can create additional opportunity costs for rebels' defection on the existing peace, and thus such programs would prevent rebels' defection and help consolidate peace. As in such case investor chooses between spending extra funds for such programs or risking loss of all revenues for a period of conflict, or even risking loss of all or part of the capital invested due to possibility of its destruction or impossibility to move such capital out of the region (such forms of investments may include factories, office-buildings, infrastructural projects), the investor will prefer initiating such program. Therefore, in this case the equilibrium of the game will be [(CSR) (Redistribute-Comply) (Comply)] – peace with decreasing grievances of the local population, consolidation of state power and effective interaction between business and society. In order to reach such equilibrium, however, the government, civil society and investor should spend much effort in order to maximize positive externalities of the CSR programs (considering that countries usually have more than one foreign investor, implementation of different CSR programs without coordination or strategic planning may not bring positive effects despite funds spent).

Results:

To sum up, if government values loss of revenues obtained from FDI as more important than the decrease in own legitimacy in the region ($F>\Delta L_g$) or at least as able to minimize costs of such decrease in legitimacy to be less than the cost of conflict ($F-\Delta L_g>-C_r$), in the short run peace will be sustained. However, a risk for the government may loom on the horizon. The population will be dissatisfied with lack or insufficient redistribution of revenues accrued by government in their region. Thus the legitimacy of rebels will be increasing in the longer run in the eyes of the local population. Such an

increase in the legitimacy of the rebels, then may translate into further rebel demands. In conflict terms such FDI induced equilibrium will sustain persistence of latent conflict and thus keep the risk of breakdown of peace in the long run. CSR program is not likely to produce a considerable effect on turning such peace into more sustainable one, whoever

Secondly, if government values consolidation of own control over the region more than revenues from FDI, the peace is dependent on the scope of positive economic externalities of foreign direct investment. If such externalities create opportunity costs perceived by rebels as higher than costs of legitimacy decreasing due to governmental redistributive policies, peace will prevail. Otherwise, if such opportunity costs are not enough to compensate for legitimacy loss of rebels, recurrence of conflict is expected. CSR programs under these conditions may only be effective if the rebels' preferences between the opportunity costs and the cost of legitimacy loss are very close to each other and can be shifted in favor of peace by the CSR programs.

Examination of Redistribution as a Continuous Variable

From our previous examination we know that in the No SCR sub-game equilibrium, the change of legitimacy (dependant on the rate of redistribution) that can be tolerated by both government and rebels is as follows:

$$-F\text{-}Cg \leq \Delta L_g^{*} \leq C_r + Ec, \tag{26}$$

If we repeat all the steps accounting for opportunity costs created for rebels by CSR programs, we will find alternative range of:

$$-F\text{-}Cg \leq \Delta L_g^{*} \leq C_r + Ec, \tag{27}$$

Which can be represented on the figure below as follows:

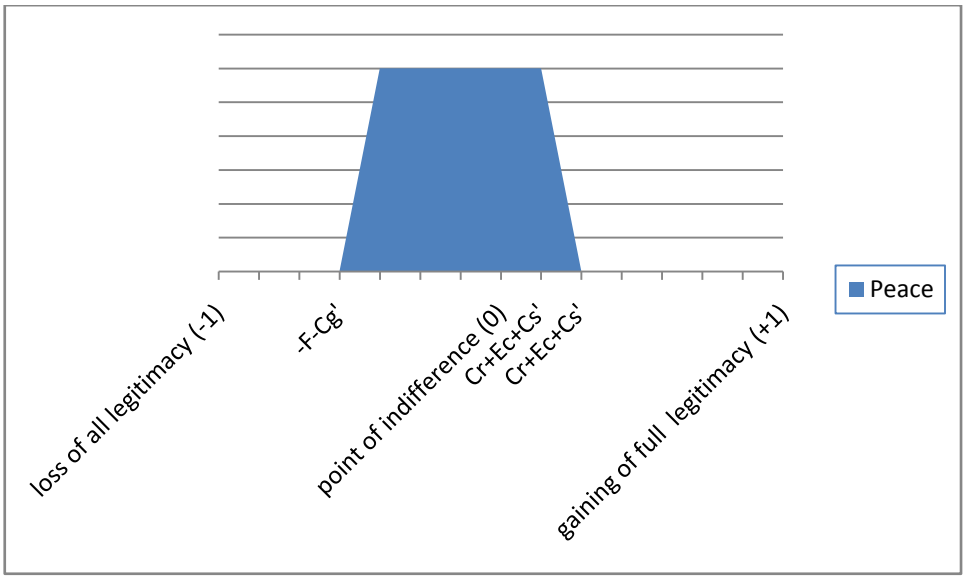

Figure 7 Peace and the Scope of Shift of Legitimacy accounting for Economic Externalities of FDI and CSR programs

These results show that initiation of a CSR may increase the range of changes in legitimacy acceptable for both parties (more particularly in this case it increases tolerance of rebels and thus allows government to provide more resources for the contested region. However, as we know from the three-actor game described above the instances when investor will have such CSR programs are rather limited.

Still if we check the level of revenues necessary to sustain such peace, we can observe an interesting relation: when we combine equations of the changes of legitimacies acceptable by both parties, we find that the necessary minimum FDI related revenues should be:

$F \geq -C_r - C_g - Ec - Cs,$

What shows that the governments sometimes may have to tolerate some costs associated with the foreign investment (providing subsidies etc.) in order to sustain peace.

CHAPTER 6

ILLUSTRATIVE CASE STUDIES

In order to provide illustration for the model of the strategic interaction between the government, the rebels and investors we present three short-cases studies on Niger, Nigeria and Turkey. All three of these countries have recently experienced intra-state conflicts and are currently on post-conflict stage. All three of them sometimes experience some forms of violence which raises questions on whether their conflicts are going to recur, however, in neither country the government had officially declared an end to peace process (or ceasefire). These case studies are based on anecdotal evidence from such secondary sources as newspapers, reports and journal articles. The Niger and Nigeria are presented from a multiple-case study perspective to provide different accounts of similar mechanisms of post-conflict settings. The Turkey's case is significantly different from the other two cases and is presented here in order to illustrate alternative type of settings.

Case-study: Niger, persistent grievances and relative peace

Niger provides an illustration for a case when the government is ready/or has to tolerate loss of own legitimacy in the region for the sake of financial inflows from foreign investment maintaining economy of the country and governmental capacity. At the same time rebels of the country despite perceived unequal distribution of the revenue tend to keep ceasefire unless there is an additional external trigger.

Niger has experienced a civil conflict between ethnic Tuareg minority and the government in 1990-1995 (CIDCM, 2006). The main demands of the rebels at that time were cultural and political rights and representation with some reference to economic development. In 1995-1997 a settlement was reached after some advances of the official army and a truce was enforced (CIDCM, 2006).

Despite settlement and some retribution/reconciliation strategies implemented by the government, the core grievances of the rebels were not addressed and related grievances fueled growing frustration. Such grievances included marginalization and

discrimination, and underinvestment of government into regional development while the region was providing 72% of Nigerien exports thanks to its uranium resources (Emerson, 2011). Moreover, the uranium mining activities put environmental conditions of the region under risk and increasing interest to this resource from European and Asian investors led to even further rise in the mining activities.

Though such grievances were present for a long time and complains that investment was ‘not helping the region economically’ but was causing environmental and health problems has been voiced since 2003 ("NIGER: New Tuareg Rebel Group Speaks Out," 2007), the conflict recurred only in 2008 when it was triggered by Tuareg revolt in Mali and governmental arrests of Tuareg minister Rhissa Ag Boula (CIDCM, 2010). Only then redistribution of uranium production related revenues became one of the main concerns and demands of armed rebels. In fact in July 2008, the leader of MNJ Aghaly Ag Alambo demanded redistribution of 20-30 per cent of all uranium revenue in Niger to the northern region (Minority Rights Group International, 2008).

In the period between the two conflicts several developments took place. Although Niger started producing uranium since 1957 even before its independence (IBP USA, 2011, p. 208), 2000s marked an important change in the uranium production in the country. Firstly, 2003 was a year when global price on uranium started to recover after more than 10 years of stagnation. Moreover, on the local level uranium production in Niger started to slowly increase (Alshanov, 2011) after relative drop in outputs of 1999-2000. Furthermore, probably related to the rising level of global prices, since 2004 one of the main uranium investors in Niger – Areva Group started to apply for additional permits for exploration (AREVA, 2009), while in 2006-2007 China entered Niger’s uranium market ("Uranium in Niger," 2015). To sum up, since 2000 influence of uranium FDI on the north of Niger was rising.

The effect of these investments on the population was two-fold in line with the proposed model. On the one hand environmental problems related to uranium mining is reported in the region, they include air pollution, sale of ‘radioactive scrap metal from the uranium mill’ on local market, and contamination of drinking water above standards of World Health Organization which were identified in 2003-2004 (Chareyron, 2008). As employment provided by Areva in 2003 was below 2000 people allegedly most of them are brought from South of the country while local population can neither work at mines (due to lack of necessary qualifications) nor sustain their traditional way of life

(allegedly due to draining of natural waters by the mining activities) (Sourt, 2009). On the positive side of economic externalities it may be possible to cite use of 800 km road built in 1980s by the French uranium mining companies and electrical power transmission line benefitting both the mine and the nearby settlement (IBP USA, 2011, p. 208). However, due to the fact such facilities were provided even before the conflict of 1990s it is possible to say that importance of such positive externalities could have diminished. Thus the net economic externalities (Ex) for the region were negative during the described period and, therefore, were not inflicting opportunity cost in case of conflict relapse.

On the part of corporate social responsibility (CSR) Areva has built and maintains two hospitals (the announced maintenance cost of 1.7 million euro for 2009)providing free care all regional population, they also fund some CSR programs including emergency aid and some forms of education (AREVA, 2011). Although hospitals could provide a source of public support for the company, the accusations of local NGOs, that the doctors in the hospitals underreport or cover up such professional disease s as lung cancer, show that it is not the case. Thus it is possible to say that although the company does engage in CSR activities, in the eyes of at least part of the local population, they do not fully compensate for the negative economic externalities, and thus are not expected to create opportunity cost in case of conflict recurrence.

Considering the rebels justification for the revolt (economic marginalization, inequitable redistribution of resources) it is clearly that the government was or was perceived as following the non-redistribution tactic of the game explained in the previous chapter. In line with predictions of our model, no immediate war was expected as the government had incentives to keep peace and enjoy and expand revenues from the related investment. At the same time the rebels had reasons to keep the truce and increase own capacities while their legitimacy (support for them from the population) was increasing due to rising grievances of the local population. The model proposed that though such equilibrium produces peace in the short run, in the long run the latent conflict between the parties would exacerbate and new wave of violence was to erupt triggered by any exogenous event. Indeed what we have observed is that despite years of growing grievances about economic underdevelopment, absence of redistribution of FDI-related revenues and negative economic externalities of the FDI in the region the conflict did not erupt till 2007 when it was sparked by the similar conflict in the neighboring Mali.

The rebellion was led by the Niger Movement for Justice (MNJ) which was attacking governmental facilities and carried out several attacks/kidnappings against foreign workers in the uranium mines (Emerson, 2011, p. 674). The conflict ended in 2009 through a negotiated settlement brokered by Qaddafi and disarmament operations were introduced. Even though after the settlement the economic situation in the region did not change significantly, the large scale violence did not resume. Since 2009 much new investors from China, India, and Korea entered the region in surge for uranium ("Uranium in Niger," 2015).

The persistence of local grievances with the foreign investment is still in place what can be seen from such events as attack on French mining company AREVA's facilities in the Somair uranium mine reported by the company in May 2013 (AREVA, 2013). However, currently government had reach a new deal with the AREVA, according to which the company will spend 123 million USD to rebuilt the road which was constructed in 1980s and that it will fund a local development project worth of 17 million USD ("Areva's uranium mining deal with Niger receives cautious welcome," 2014). Moreover, in 2012 the government announced a 2.5 million USD Strategy for Development and Security (SDS) aiming to 'devolve power to local communities' for the northern areas that would be financed by the government and external partners (Lebovich, 2013), though reportedly not much of this program had been implemented yet. Such program apparently would on the one hand redistribute the revenues for the region, and at the same time it would solve the legitimacy-related commitment problem as it would integrate local community into the decision-making process.

The new SCR projects by Areva may not be enough to compensate for (at least perceived) negative externalities of the uranium mining. Thus apparently the situation once again may only return to the stage of latent conflict, unless government can succeed in transferring power and finances to local communities at the same time.

To sum up the developments in Niger and the recurrence of the conflict in 2007 can be explained by the model proposed in this paper showing that equilibrium with no open warfare can be reached at the point, where the government enjoys large revenues from the investment, while rebels despite existing grievances among the population prefer to refrain from large-scale violence and increase own force instead**.**

Case Study: Nigeria – Fragile Truce

Nigeria is another country endowed with natural resources (particularly oil) and having long history of violence. Similarly to Niger, the FDI in natural resources in Nigeria have been a problematic topic for a long time as it creates vital revenues for the government but also provides a source of conflict in the region of Niger Delta. In this case study we will examine Nigerian case in line with our model in order to see why truce is still in place and whether recurrence of conflict is expected under current conditions. We will firstly present a short overview of the conflict and then discuss the developments of the current post-conflict stage in Nigeria.

Towards 2010 Nigeria became the 19th recipient of foreign capital in the world and accounted for 30% of overall FDI inflows in the African continent (Idowu & Awe, 2014). While investment in oil sector remained the sector with largest presence of MNCs in Nigeria, it also attracted broad attention due to the impact of such investments on conflict in the country. Despite high revenues for the government from the oil production, local people received few benefits and remained impoverished. Moreover, oil extraction in Niger Delta negatively affected local people due to environmental effects of oil spillovers. According to the recent estimates cleaning up of which would require 30 years and 1 billion dollars to be cleaned-up, while the soils in some regions are contaminated for more than 5 meters deep (Vidal, 2011). As a result, of grievances related to economic underdevelopment and environmental problems in 1990s oil investors were opposed by wide protests and when the government repressed them, violence erupted in the country (Campbell & Carment, N.D.).

The conflict continued for about 20 years with ups and downs and only in June 2009 the government attempted to settle the conflict by offering 90 day long 'unconditional amnesty' for the insurgency members (Canada: Immıgratıon and Refugee Board of Canada, 2011). While firstly the offer was mostly rejected by militants, later MEND - Movement for the Emancipation of the Niger Delta (one of the main militant groups of the conflict) announced unilateral ceasefire and towards autumn of that year almost all rebel leaders and about 26 000 militants accepted the amnesty (Canada: Immıgratıon and Refugee Board of Canada, 2011).

The amnesty resulted in monthly payments and training programs for ex-militants, however, it failed to address wider and deeper grievances of the local population despite rapid rise in revenues from the increased oil production (Canada:

Immıgratıon and Refugee Board of Canada, 2011), which fell before the amnesty by forth (McNamee, 2012). Although the wage payments to the militants continue, some got dissatisfied with lack of developmental changes or problems with distribution of the payments (Morehod.ru, 2011). Therefore, some militants renege the amnesty and carried out sporadic attacks, such as attack on oil trunk line in 2012 by a group called themselves also MEND though other MEND leaders continued cooperation with the state (McNamee, 2012).

The government also had carried out several military raids against remaining (active) militant camps, some ex-MEND commander and militants accused of reneging the truce. In November 2010 about 60 militants were arrested after a military raid on their camps; the following month clashes continued between the Joint Military Task Force (JTF) and militant Niger Delta Liberation Force (NDLF) with alleged casualties of villages amounted to 50 (Okafor, 2011). In 2011 after a cross fire between military and NDLF, a new major military operation was conducted against a militant group accounting for 70-100 militants active in the area ("Nigerian soldiers attack militants in Niger Delta region," 2011). Despite such occasional violence neither the government nor the ex-rebels announced officially the end to ceasefire and new rebel groups do not engage in consistent warfare (rather conduct occasional attacks)

Analyzing this conflict from a perspective offered by this paper, we can define the country as post-conflict as there was an amnesty as a start of a peace process with most of the militants still following the truce. Due to the rapid increase of oil production after the amnesty we can examine this case as close to the situation when investor entered after the ceasefire. Regarding the governmental announcement of redistribution of the profits we can examine the economic commitments made by government under the amnesty program. However, although based on the conditions of the amnesty some payments were done and wages are still paid to the ex-rebels, such payments cannot be deemed as redistribution policy considered by our model. (Because our model uses population-centric approach and evaluates changes in legitimacy as induced by the reaction of population redistributive policies, such legitimacy-inducing redistribution should be focused the local society). Thus despite the large payouts to rebels the current interactions are realized in settings of the ‘Not redistribute’ sub-game.

Our model predicts that if the government does not redistribute the new FDI-related revenues to the population the support of the population to the government will decrease, while rebels' legitimacy will increase. As a result, the rebels are expected to keep peace and increase own power which is dependent on the rising grievances of the population. And such is the situation in the region. But is this situation in place and why a different set of policies did not take place?

Our model predicts that such peace with latent conflict is likely in situation when rebels value change in legitimacy (i.e. population's support/control over population) as more important than the opportunity costs provided by the foreign investor, while the government at the same time values revenues from FDI as more important than the change in the governments legitimacy in the region. The first condition is easily to establish in Nigerian case as the main source of FDI in the Niger Delta is oil. And as we had discussed in the literature review part, FDI in natural resources tends to produce minimum positive externalities, while on the contrary such FDI tends to create negative economic externalities such as oil spills in the Nigerian case. Thus, it is obvious that as positive externalities of FDI in Nigeria are low, the rebels would value their legitimacy/control over the population as more valuable than non-existing positive economic externalities. At the same time the government in Nigeria is highly dependent on the oil revenues – about 75 % of its budget comes from oil ("Nigeria forced to revise budget as oil prices remain low," 2014). Thus loss of some part of the revenues due to relapse of the conflict would mean for the government lost in the budget and thus decrease in the state's capacity to operate. Therefore, it is possible to argue that the government values such revenues as more important than loss of some legitimacy in the region.

If we consider constrains of the government and the nature of the FDI, it is clear that the behavior of Nigerian actors is consistent with propositions made by our model which would indeed predict latent conflict and persistence of population's grievances. Therefore, it is possible to argue that the FDI in Nigerian case indeed acted as an incentive mechanism, providing the government incentives to keep peace, that it did not invoke the opportunity cost mechanism due to the lack of positive economic externalities. It is difficult though to account for legitimacy mechanism in this case as more detailed data is necessary. However, some accounts say that the lack of effectiveness of the economic part of the amnesty program was because the ex-rebel

leaders mismanaged the distribution of wages to low-rank rebels what led to even additional grievances and creation of alternative rebel factions (Morehod.ru, 2011). Though ideally such actions could be interpreted as challenge of the government's legitimacy, this mismanagement of the program can be just the reflection of greed of those who wants to benefit from the governmental sources.

To sum up, the Nigerian case supports the proposition of our model that in case of low positive economic externalities, and government's preferences for revenues of FDI a peace is likely to be maintained in the short run, but in the long run the persistent latent conflict may once again turn into violence, because as grievances of population will rise the support for the state will follow and more people would be ready to support old (reneging) or new militant groups. Thus in the long run the ex-militants can either rise their demands and sustain policies favorable for them, or recurrence of the conflict can be sparked by any new variable.

Case Study: Turkey

We present a case of Turkey as a case of mechanism opposite those illustrated in analyses of Niger and Nigeria. However, we should notice several difficulties of analyzing Turkey from the perspective of our model. First of all, that the data on Turkey that we use, provides information on a total investment in the conflict affected region without differentiation between foreign and domestic investments. Secondly, while in Nigerian and Nigerien cases presence of FDI in natural resources resulted in the fact that the major investors in the affected regions were the mining companies of limited number, in Turkey the investment sectors promoted and growing in the affected region are comprised of large number of different companies in different sectors. Thirdly, because of such nature of the investment and lack of exact information of revenues from such investments, we will provide just tentative overview of the case adopting existing information to our model. The reason for our use of such case at all, is that, as our model defines four sets of different conditions that define the nature of interactions between the actors (based the relation between ΔL_g and F, between ΔL_r and Ec), this case significantly different from Niger and Nigeria will help us demonstrate some mechanisms of our model which could not be demonstrated in previous cases. Moreover, we acknowledge that as most contexts with similar characteristics of non-

natural-resources FDI would provide similar difficulties, a reliable analysis of such cases would require much more systematic analysis based on broader range of sources.

For more than 30 years Turkey experienced conflict between the government and militant Kurdish Workers Party (PKK) with violent clashes and casualties on both sides. Despite some advances in 2005-2009 and the subsequent Oslo Peace Process that took place in 2009-2011, the conflict renewed in 2012 with sporadic violence (Crisis Group 2014). However, continuation of secret meetings and negotiations between the government and one of the PKK leaders imprisoned Abdullah Ocalan led to a new phase of cease-fire announced publicly in the end of 2012 (Sputnik News 2015).

A series of negotiations between Öcalan, active PKK arms in Kandil and European arms of PKK took place in February – March 2013 and led to announcement of unilateral ceasefire by PKK on March 23, 2013 (BBC 2012). Retreat of PKK from Turkey was planned to start on 8 May 2013 and the second stage of the peace process started on 24 June 2013, though was paused in September 2013 (Şimşek 2015)

Though a number of clashes and attacks took place since then, sides have not renounced the peace process officially, and the overall scale of violence has decreased comparatively to the pre-'peace process' period. The conflicting parties have started a peace process, some stages of it were implemented and overall war is absent. As at the beginning of this paper we defined post-conflict situation as a transition from war to peace or as a stage of conflict with absent war but risks of violence, it is possible to argue that Turkey is in the post-conflict stage now despite low scale violence.

In order to understand the effect of investment on the dynamics of this state we can analyze the changes in governmental and private investment during the last years. On the investment side, firstly it is necessary to acknowledge that there is no major natural resources production; therefore, no one particular investor or sector accounts for the whole region. The main energy projects in the region – i.e. hydroelectric plants - are funded and operated by the central government (GAP 2014). Apart from such state run enterprises towards 2015 investments in East regions of Turkey (which may be seen as the contested regions) had risen dramatically: during the five years from 2010 to 2015, capital investments in Siirt including FDI increased 26-fold reaching 867 million Turkish Liras from 34 million Turkish Liras in 2010, in Mardin during the same time period total investment volumes increased 10-fold, while in Batman a three-times

increase was observed ("Huzur ortamı Doğu'da ekonomiyi canlandırdı," 2015). Among the known foreign investors in the region there are MSA Brother International planned to invest 6 million dollars in Berçelan Water Packaging Factory in Hakkari (though no reports about its later activities are found, it is still listed on the Turkish Ministry of Economy web-site as a company operating in Turkey as of 30.06.2015(Ministry of Economy, 2015)), while a number of local manufacturing firms are investing in the regions as well (İlhan, 2010). Considering unemployment rates in the region hovering around 14.5% in South Anatolia, and around 21% in the Mardin, Şirnak, Şiirt and Batman regions of South-East Anatolia supporting mostly Kurdish political actors[11] (as opposed to the Turkish average of 9,7%) (GAP, 2014), the benefit these new economic enterprises provide in terms of employment and other economic externalities is notable.

On the state-redistribution part as of 2011 the state was spending on the South-East Anatolian region several times more than it was obtaining through taxes. Since the Oslo process the share of public investments in the South-East region was between 11% and 14% of country wide public investments (what accounted for expenditure of around 14 billion of Turkish liras for the period of 5 years up to 2012), which is higher than in years previous to the start of peace processes (GAP 2014). Moreover, the state-led South-East Anatolian Development Project (GAP) reports state investments into irrigation systems, and increase in exports and economic development policies implemented between 2008 and 2012 (GAP 2014). However, if we look into the revenue part of the state, we will see that the government actually minimizes potential revenues that can come from the private investment in the region. In 2012 the government announced that investors in the region will be exempted of taxes and will be enjoying subsidized interest rates (Babacan, 2012), with all domestic and foreign investors able to benefit from such policies. It is important to note that such policies are not uniform around the country and the highest governmental support and tax reductions is proposed exactly for the regions of Eastern Turkey (Investment Support and Promotion Agency, n.d.).

Though the evidence we provide is not systematic, it give an insight into the ongoing policy. As we see the government provides special policies in order to attract

[11] Definition made according to the voting results of 2014 these regions voted for pro-Kurdish political parties and individuals ("2014 Yerel Seçim Sonuçları," 2014).

domestic and foreign investor in the region while reducing own revenues to minimum (i.e. the investment policy for the region frees large, strategic and some other kinds of enterprises from income taxes at all). Moreover, the governmental expenditure on the region (through public investments etc) is remains high. Thus it is clear that considering our model, the government can be classified as one valuing change in own legitimacy more than the potential FDI related revenues. Thus the current situation is characterized by high values of redistribution (or more properly public investment which is higher than the investment related revenues) and possible positive economic externalities such as employment and services provided by the firms. According to the model we can predict that in such case the government rebels will be making preference between the economic benefits of investment but losing some bargaining power against the state, and returning to conflict to preserve own bargaining power but losing positive externalities of investments in the region. Thus attacks against governmental projects are possible if the risk of loss of bargaining power is perceived. While if the rebels value cost of losing economic externalities for the region higher than cost of such risk, the peace will prevail.

What we observe is that during the years of peace process the investments initiatives that were under attack were mostly related to government operated projects like electric power plants. An example for such attacks can be the PKK attack of Silvan Dam Construction site by detonating bombs placed in culvert in May 2015, when luckily no casualties were registered (Haber 7, 2015). Other attacks during the last years were mostly linked to specific political events like the Kobane conflict in Syria, or current parliament elections. Moreover, the targets of such attacks were such state facilities as municipality or schools (Haber 7 2013, Hürriyet 2014) with few reports on attacks on private sector establishments.

We may explain such situation if we refrain from using discrete notions of peace and conflict and allow for some middle values between them. Then, the discussed above dynamics may suggest that the governmental investments indeed were perceived as a risk of decrease of the rebels' bargaining power. Therefore, the rebels were likely to engage on attacks against such programs. At the same time as increase of private investment in the region created opportunity costs for rebels, thus preventing outburst of conflict. Apparently as such balance between risks losing bargaining power (i.e. legitimacy) and opportunity costs induced by investments will be kept; the current state

of no-conflict may persist. However, as such situation is not a stable equilibrium and the reliable commitment problem persists, some policies such as promotion of CSR programs implemented by enterprises or policies to increase positive externalities would be necessary to keep the peace under the increasing rates of redistribution/public investments (as suggested by the examination of redistribution rates and legitimacy changes as continuous variables), or reversely, in case of economic decay in private sector, the redistribution/public investment rates may be decreased and such activities may be delegated to non-governmental actors in order to decreased the perceived risks.

CHAPTER 6.

Conclusion and Policy Recommendations

Though rational models provide possibility to analyze different phenomena in different contexts, the need for simplification of such phenomena may let to omission of some important contextual differences. This model is not exceptional in this sense as it requires one to simplify complex post-conflict settings to three-actor interaction. We also acknowledge that the real life circumstances are complicated by additional concerns of the conflicting parties, influences of other external and domestic factors, and possible fragmentations and new concerns within themselves. However, we argue that if other such conditions are constant, this model can provide an explanation for the direction of the possible impact of foreign direct investment on the peace building.

Another weakness of the model may be rooted in the difficulty of its falsification due to difficulty measuring and comparing de facto preferences of the parties. However, the model still provides an insight into the direction in which the process will move under the particular circumstances.

We also should acknowledge that the model approaches all the post-conflict situations as similar with particular balance of power, while in practice each post-conflict situation may have different levels of risks of conflict recurrence, different levels of economic, political and social risks. Thus there is a possibility that the strength of FDI effects predicted this model may also vary from case to case. Therefore, in order to test this model in real life situations such risk related characteristics of a country should be accounted for. Moreover, differences in conflict proneness between the countries may lead to a selectivity bias when comparing countries which received FDI and those which did not. Such selectivity bias can occur due to the possibility that foreign investors a priori prefer countries with lower risks. In order to tackle such problem in turn it can be helpful to use controls for the factors attracting FDI inflows, economic and political characteristics of the countries and their risk proneness.[12]

[12] The possibility of similar selectivity bias in studies on post-conflict peacebuilding is addressed by Fortna (2004) in the quantitative analysis of the effect of peacekeeping operations on the duration of peace. In order to prevent such

Defining the conditions in which foreign investment can contribute to or harm the post-conflict peace building is crucial as economic needs in most post-conflict countries are urgent while the peace in such circumstances is very fragile and may be easily destructed. Our model presents an explanation for why sometimes investment although providing the urgently needed finances for states may actually unwillingly cause renewal of war and suffer own losses, and why even sometimes such seemingly pro-peace state practices as redistribution and public investment in development of a disputed region may in reality result in new violence. We argue that while the most sustainable and beneficial for the long lasting peace conditions are likely to emerge when FDI brings large positive economic externalities and is complemented by redistributive policies of the state, and when population values such economic externalities more than the state's redistribution.

Alternatively truce may be still sustained when government does not provide redistributive policies but receives high revenues from the foreign investors, and when government values such revenues higher than the possible decrease of its legitimacy over the disputed territory. However, it is necessary to underline again that though in the short run truce will hold, the latent conflict in the region will be simmering, the grievances of the local population will be rising and the support for rebels offering alternative arrangements will increase. Such situation in turn can lead to loss of governmental control over the region in the long run or renewal of violence sparked by any additional factor.

In contrast and rather surprisingly redistribution of revenues accrued from the FDI seems to be likely to lead to recurrence of violence. The reason for such outcome is the competition for legitimacy between the state and the rebels. Thus provision of new services and public investments from the central government may endanger positions of the rebels if they do not have a say in the allocation of such resources, and thus may motivate rebels to continue conflict in order not to have to reduce own demands.

However, we do not propose that the government should not redistribute the revenues at all. Alternative models, estimating the range of peace-allowing changes in legitimacy, showed that there is some flexibility in the rates of redistribution. Moreover, these models has shown that with increase of positive externalities of FDI and presence

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bias the author firstly controls for the factors that can determine entrance of peacekeeprs and the level of 'difficulty to maintain peace'(Fortna, 2004).

of corporate responsibility programs conducted by foreign companies, such flexibility of changes of legitimacy (dependent on the rate of redistribution) is higher. Thus policies aimed at promoting CSR programs, limiting negative externalities of investment and fostering positive externalities of investment are likely to broaden the scope of changes of legitimacy tolerable by the rebels and, thus, would help government to consolidate own power in the region without endangering peace.

Such findings lead to several for policy recommendations. First of all, this finding shows that although provision of public services and investments is usually seen as a tool to strengthen peace and stability (UNDESA 2010), the question of who, how and to what extent provides the goods may be decisive for sustenance of peace. It is important to prevent the change in the initial balance between the state and the rebels and thus not to create a commitment problem, and at the same time to improve conditions of the contested population and thus prevent their grievances. For such a purpose the state may use alternative models of service provision such as Independent Service Authority boards of which can include representative from different parts of society and thus solve the problem of legitimacy competition (Collier 2009). An alternative solution for such problem can be delegation of some financial resources management on local/regional level what also will reduce the resentment against the central government.

At the same time considering the investors, they are more likely to sustain peace if their investments produce large and positive economic externalities highly valued by the local population. For this end investors might be more interested in engaging in manufacture related project or to allocate special funds for community capacity building projects.

Finally, although another equilibrium of not redistribution strategy is likely to be peace, the governments of post-conflict countries may be interested in shifting from such truce period into the Redistribution - Comply stage in order to make their truce more sustainable.

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