Conflict and Foreign Direct Investment: The Colombian Case

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The Foreign Direct Investment (FDI) is often viewed by policymakers as a crucial tool for supporting development, growth, and productivity in emerging economies. Investors, however, carefully evaluate the risks and return prospects when making investment decisions. Their choice of investment location is influenced by the overall investment environment that aligns with their preferences. From the perspective of the receiving country, it must ensure the country presents an attractive proposition to potential investors. Importantly, maintaining peace and stability emerges as a key strategy to attract FDI. Research indicates that countries with higher political instability are less likely to receive FDI. Therefore, a country in the midst of a civil unrest may take measures to resolve violence and conflict by, for instance, strengthening law enforcement, increasing military expenditure, and adopting aggressive military policies. These actions can impact investor expectations and subsequently determine the amount of FDI a country receives.

The Internal Armed Conflict of Colombia, ongoing since the late 1950s, involves various parties such as the Colombian State, extreme left guerrillas, extreme right paramilitary groups, drug cartels, criminal gangs (Bacrim), and Organized Armed Groups (GAO). The ‘Bandolerismo’ movement around 1930 marked the beginning of the conflict, which was characterized by organized groups of peasants with liberal, conservative, or communist ideologies engaging in Robin Hood-type activities. Post-‘Bandolerismo’, criminal activities persisted due, primarily, to the emergence of criminal organizations, 18 new armed groups, and new political groups with different ideologies. The severe economic and social impact of the conflict prompted a shift in strategies adopted by the Colombian government. Before the 2000s, negotiation strategies were predominant, but in 2002, President Álvaro Uribe Vélez initiated aggressive military actions against terrorist groups. The government implemented the "Política de seguridad democrática," aiming to recover territorial control, protect the population, eliminate the illicit drug business, and maintain a deterrent capacity. Data suggests a significant decrease in violent acts after 2002, and there is a notable difference in FDI inflows before and after 2002. While it is not possible to assert with certainty that this dynamic is solely due to hawkish policies, this research seeks to elucidate the impact of these policies on FDI in Colombia.

Our study has two main objectives. First, it aims to develop a new theory that addresses the interplay of law-and-order sector with the rest of the economy. Our constructed theoretical model allows us to study the effects of a hawkish policy on the FDI flow. Second, using our theoretical results as a foundation, we empirically study the impacts of these hawkish policies on FDI inflow using the empirical case of the Colombian economy. Our empirical strategy involves employing difference-in-differences and event study methodologies to compare FDI inflows in Colombian municipalities exposed to the conflict to those that are not before and after the shift in conflict strategy in 2002.

On the theoretical front, our model examines the impact of imposing a tax to finance the law enforcement sector for counterterrorism efforts on FDI levels in the recipient nation. The model considers a small open economy with three sectors: a law enforcement sector, a terrorism-related sector, and a licit composite sector. Both terrorism and law enforcement sectors use labor in their production functions, while the licit composite good relies on foreign capital. Terrorism negatively affects the production of the licit composite good through actions like public and private property damage, prompting the government to increase expenditure in the law enforcement sector by imposing a tax rate on the licit production sector. Results indicate that a small economy might experience reduced FDI after imposing a tax to combat terrorism if investors have low risk-aversion. However, if investors exhibit greater risk aversion, fighting terrorism through taxes could make the country more attractive to foreign investors. In essence, more risk-averse investors may be more willing to pay a tax to counter terrorism.

On the empirical front, we first build panel data encompassing 1121 municipalities in Colombia between 1994 and 2010. The main outcome variable of interest is FDI inflows. The control variables considered include key violence-related measures and socio-economic variables, including the number of victims related to armed conflicts, cocaine production, and population density, among others. For difference-in-differences and event studies, we need to identify municipalities affected by armed conflict (treated municipalities, i.e., those who received the new military policies) and municipalities that were not affected by armed conflict. To construct the exposure to armed conflict, we used detailed microdata that included such information as date, location, the number of victims involved, and the identity of the perpetrator. Similar to Fajardo-Steinhäuser (2023), we first created a discrete variable to measure the extensive margin of armed group violence. This variable takes the value of 1 if there was at least one armed-conflict crime in at least 60% of the years from 1994 to 2010. As an alternative, we established that a municipality is considered under the control of armed groups (treatment group) if there was at least one crime committed by any armed group in 60% of the years during the period from 1994 to 2010.

The empirical analysis suggests that after 2002, there was a positive and statistically significant difference in the FDI received by Colombian municipalities that had a presence of armed conflict versus those that did not. In particular, the military strategy and measures carried out after 2002 in municipalities that had a presence of armed conflict are the cause for these municipalities receiving, on average, 1.6 million dollars of FDI net inflows more than municipalities without the presence of armed conflict. These results are robust to (i) the parallel trends assumption, (ii) a different criterion to determine the presence of armed conflict (based on the intensity of the conflict per 10,000 habitants), (iii) different percentages in extensive and intensive identification of treated municipalities, and (iv) alternative ways to measure municipal FDI.

This study contributes to the understanding of the relationship between conflict and economic growth, particularly in a developing country context. The interest in a short- and long-term causal effects of conflict and civil unrest on development prospects of developing countries, such as Colombia, has drawn an increased scientific scrutiny recently (Bernal et al., 2024; Fajardo-Steinhäuser, 2023). Our work contributes to this line of work by illuminating the effectiveness of the 2002 conflict resolution measures taken by the Colombian government on the country's FDI inflows. As such the paper positions itself to generate productive discussions at the AAEA meetings.

References

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