Conflict and Foreign Direct Investment: The Colombian Case

Policymakers often see FDI as crucial for supporting development, growth, and productivity in emerging economies. Investors carefully assess risks and return prospects when making investment decisions. Since political stability is key for attracting FDI, governments in conflict-prone countries may implement policies, such as strengthening law enforcement, increasing military spending, and adopting aggressive military measures, to create stability and influence investors' expectations and FDI flows. We analyze the effects of such a policy regime on FDI inflows using the case of Colombia as a natural experiment.

Colombia's internal armed conflict was approached by pacifist measures before the 2000s. However, in 2002, the policy shifted towards aggressive military actions against armed groups. To examine the consequences of this policy change, we first develop a theoretical model to understand the effects of a hawkish policy on FDI flows. The results suggest that a small economy may see reduced FDI after imposing a tax to combat terrorism if investors have low risk aversion. Conversely, if investors exhibit greater risk aversion, fighting terrorism through taxes could make the country more attractive to foreign investors.

Empirically, we build panel data on 1,121 Colombian municipalities between 1994-2010 and use difference-in-differences and event study approaches to compare FDI inflows to treatment and control municipalities before and after the 2002 policy shift. Following the literature, we identify treatment and control municipalities based on their exposure to armed conflict, which was the primary target for military interventions. We find that municipalities with armed conflict received, on average, more FDI per year compared to conflict-free municipalities. Our findings are robust to the parallel-trends assumption, alternative controls, alternative constructions of control and treatment groups, and alternative ways to measure municipal FDI. The study has implications for understanding the role of conflicts and measures to address them in promoting growth in developing countries.

Keywords: FDI, Internal conflict, Hawkish policy.
JEL: O1, F2.

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