Rebuilding Fiscal Institutions in Postconflict Countries[1]

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May 2004

Abstract

This paper reviews the challenges and experiences in rebuilding fiscal institutions in post-conflict environments, based on advice from the IMF's Fiscal Affairs Department to selected countries. The recommended strategy involved a three-step process of (i) creating a proper legal framework for fiscal management, (ii) establishing a central fiscal authority and a mechanism for coordinating foreign assistance, and (iii) designing appropriate tax policies while simultaneously creating simple tax administration and expenditure management arrangements. The advice was tailored to the circumstances of postconflict countries, and in some cases involved transitional measures that were not first best from an efficiency standpoint. In a similar vein, recommendations on revenue administration and expenditure management focused on the most basic tasks and procedures. At the same time, care was taken to ensure that these measures were consistent with the eventual transformation to a modern fiscal management system.

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[1] This paper draws on the insights from a number of reports written by staff of the IMF's Fiscal Affairs Department. The authors would like to especially thank Steven Symansky for sharing his notes on fiscal institution building in postconflict countries and his extensive comments on the first draft of the paper. We would also like to thank Bernadin Akitoby, Thomas Baunsgaard, Priyaranjan Desai, Robert Gillingham, Davina Jacobs, Eric Lesprit, and Eivind Tandberg for their comments. Valuable research assistance was provided by Larry Cui and Chris Wu. The views expressed in this paper are those of the authors and do not necessarily represent those of the IMF or IMF policy.

I. INTRODUCTION

The proliferation of violent conflicts over the last two decades has taken a heavy toll on life and property. The effects of conflict have often spilled across national boundaries, for example through the disruption of economic activity and the influx of refugees. Furthermore, countries in conflict have a high tendency to relapse into subsequent conflicts.[2] As such, the legacy of conflict—and its adverse effects for socio-economic development—have been difficult for many countries to escape.

One of the most destructive effects of conflicts is the damage they inflict on the social, economic, legal, and political organization of a society, that is, its "institutions." In particular, conflicts affect at least five market-supporting institutions: property rights, regulatory institutions, institutions for macroeconomic stabilization, institutions for social insurance, and institutions for conflict management (Rodrik, 1999). Recent empirical evidence shows a strong relationship between these market-supporting institutions and economic growth (North, 1990; Olsen, 1993; Rodrik, Subramanian, and Trebbi, 2002; Acemoglu and others, 2003; and Rodrik, 2004). Hence, it is not surprising that institutional reconstruction and development should be one of the key priorities in the postconflict era. Reestablishing institutions can help to sustain peace by laying the groundwork for a resumption of economic activity. Sustained peace, in turn, can further accelerate the process of recovery in the aftermath of conflict.

This paper focuses on a small but important set of economic institutions, namely, those in the fiscal area. The paper reviews the challenges and experiences in institution and capacity building in the fiscal area in postconflict countries. The paper is organized as follows: Section II provides an overview of the macroeconomic and fiscal consequences of conflict by examining changes in key variables immediately before, at the end of, and after a conflict in a sample of postconflict countries; Section III reviews the literature on some of the key aspects of rebuilding economic institutions in postconflict environments; Section IV discusses experiences in reestablishing fiscal management in postconflict countries, and analyzes, on the basis of the advice provided by the IMF, key priorities for rebuilding fiscal institutions in the early postconflict period; and Section V presents a summary and conclusions.

II. MACROECONOMIC AND FISCAL SETTING IN POSTCONFLICT COUNTRIES

The challenges facing postconflict countries can be gauged by economic conditions confronting them in the aftermath of a conflict. Figures 1–6 present information on macroeconomic and fiscal conditions in the year before the start of the conflict, the last year of the conflict, and four years after the conflict.[3] The data presented cover 13 middle- and

[2] Bigombe, Collier, and Sambanis (2000).

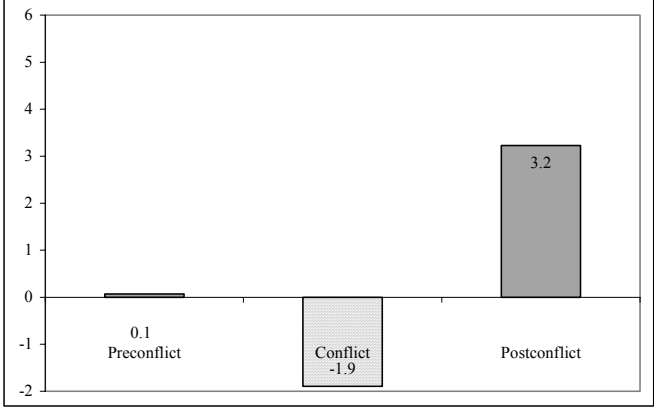
[3] This implies that for a conflict that ended in 1995, for example, the postconflict year would be 1999. While difficult to precisely judge, we assume that after 3-4 years after the end of conflict, economic conditions return

(continued)

low-income countries and 14 conflict episodes which ended by 2000.[4] [5] These figures only capture changes in countries that existed before the conflict, and thus do not represent the fiscal effects of hostilities on countries or regions that were born out of these conflicts (e.g., East Timor, Kosovo).

Macroeconomic imbalances—already severe at the onset of the conflict—were generally exacerbated by the hostilities. On average, real GDP fell significantly in these countries during the conflict (Figures 1 and 2). This is consistent with earlier studies on the economic consequences of conflict.[6] Inflation, already at high levels before the onset of hostilities, more than doubled by the end of the conflict period to an average of over 100 percent (Figure 3). In part, this owed to the failure to rein in burgeoning budget deficits (see below).

Figure 1. Real GDP Growth in Postconflict Countries 1/
(Annual percentage change)



Source: IMF, *World Economic Outlook* database 2004.
1/ Based on a sample of 13 countries with 14 conflict episodes. "Preconflict year" refers to the last year before the beginning of a conflict; "conflict year" refers to the last year of a conflict; and "postconflict year" refers to data four years after the conflict or, for conflicts that have recently ended, data for the latest year available after the conflict.

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to a more normal state of affairs, and institutions resume their normal functioning. In a related vein, Collier and Hoeffler (2002a) suggest that the capacity of postconflict countries to effectively absorb aid is higher four years after the conflict than in the immediate post-conflict period. In cases where the conflict ended after 1998, the present paper used the most recent data available. As a result, the average number of years between the last conflict year and the postconflict year is 3.1.

[4] In identifying conflict episodes, we follow the Stockholm International Peace Research Institute's (SIPRI) definition of major armed conflicts. The SIPRI definition of armed conflicts includes intermediate armed conflict and war. Intermediate armed conflicts are those that result in 25 to 999 battle-related deaths a year and an accumulated total of at least 1,000 deaths. War is defined as those conflicts where battle-related deaths exceed 1,000 per year. See Appendix I for a list of countries and the time periods the preconflict, conflict, and postconflict years. The choice of conflict countries was restricted to those which had available data for the relevant fiscal aggregates.

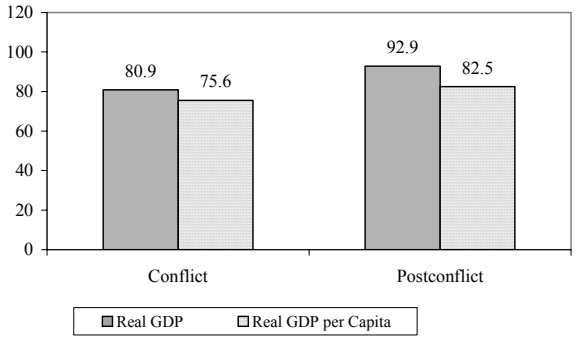
[5] The analysis presented in this section should be interpreted with caution. The evolution of the macroeconomic variables over the conflict cycle is influenced by a host of factors independent of the conflict itself. No adjustments are made in the data to correct for these factors. In addition, the sample size for some of the macroeconomic and fiscal variables differs.

[6] See Collier and others (2003) and Gupta and others (2004).

Macroeconomic challenges were particularly severe in the fiscal area. Fiscal deficits (measured on a before-grants basis) at the end of the conflict were substantially higher than at the start of hostilities (Figure 4). This expansion in the deficit was due to both sharp increases in government expenditures (of 4 percent of GDP) and a substantial slippage in the revenue effort. Grants and foreign financing rose sharply during the conflict period, helping offset the adverse macroeconomic effects of these higher deficits (Figure 5); nevertheless, the domestic financing requirement rose to close to 11 percent of GDP at the end of the conflict.

Higher defense spending during the conflict contributed to the surge in budget deficits (Figure 6). Military spending, already high by international standards, almost doubled and reached 10 percent of GDP. Wage outlays (some of which are captured in the military spending data) also rose by about 2 percentage points of GDP.

Figure 2. Real GDP and GDP per Capita in Postconflict Countries 1/
(Index, preconflict year =100)



Source: IMF, *World Economic Outlook* database 2004.
1/ Based on a sample of 13 countries with 14 conflict episodes. See Figure 1 for definition of preconflict, conflict, and postconflict year.

The macroeconomic picture generally brightened in the postconflict period. Real growth resumed and averaged about 3 percent. On the other hand, four years after the conflict ended, real GDP and GDP per capita had not climbed back to their preconflict levels. Inflation had fallen to more manageable levels, but at about 40 percent, still posed an obstacle to higher growth.

Ending conflict yielded a tangible peace dividend. Budget deficits fell sharply, but remained high at 13 percent of GDP (11 percent of GDP on an after-grants basis). Domestic financing of the deficit, however, fell to less than 5 percent of GDP, contributing to greater macroeconomic stability. Revenues rebounded and rose as a share of GDP, but did not reach their preconflict levels. Military spending declined, but still eclipsed its preconflict levels. Total government spending (net of military outlays) rose. As such, it

Figure 3. Consumer Price Inflation in Postconflict Countries 1/
(Annual percentage change)

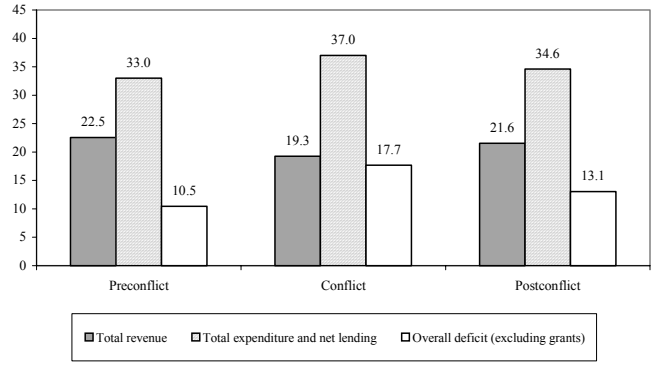
Source: IMF, *World Economic Outlook* database 2004.
1/ Based on a sample of 11 countries with 12 conflict episodes. See Figure 1 for definition of preconflict, conflict, and postconflict year.

appears that the peace dividend was used by countries to address—but not fully correct—fiscal imbalances, as well as to attend to pressing social needs by further increasing government spending.[7]

III. Review of the Literature

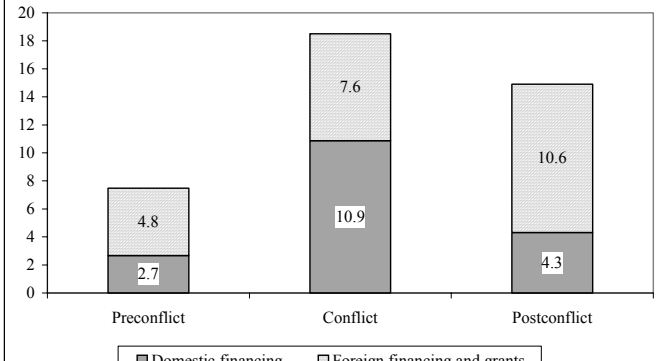
The literature on postconflict aid highlights the important role of rebuilding institutions to facilitate the resumption of economic development and the effective absorption and management of aid inflows. The pattern observed in many postconflict countries is for aid to surge immediately after the cessation of hostilities and gradually taper off thereafter. However, as Collier and Hoeffler (2002a) argue, this pattern of aid flows leaves much to be desired, as the capacity of these countries to absorb aid is rather low in the early postconflict period. This is partly due to weak political and administrative capacity. In this environment, aid cannot be used effectively for poverty reduction. Provision of large amounts of assistance could therefore lead to a deterioration in governance and a further decline in aid effectiveness. Furthermore, conditionality is ineffective in encouraging reforms during this period, as at the early stages of reconstruction, government ownership of reforms may be lacking. As such, increasing aid effectiveness in this period requires the strengthening of technical and administrative capacity. This implies that early in the postconflict phase, development partners should assist countries in this endeavor, while moving cautiously in implementing structural reforms and funneling large amounts of aid to these countries.

Figure 4. Fiscal Aggregates in Postconflict Countries 1/
(In percent of GDP)



Sources: National authorities and IMF staff estimates.
1/ Based on a sample of 13 countries with 14 conflict episodes. See Figure 1 for definition of preconflict, conflict, and postconflict year.

Figure 5. Financing of the Budget in Postconflict Countries 1/
(In percent of GDP)



Sources: National authorities and IMF estimates.
1/ Based on a sample of 10 countries with 11 conflict episodes. See Figure 1 for definition of preconflict, conflict and postconflict year.

[7] For an examination of the impact of conflict on social indicators, see Gupta and others (2004).

The importance of rebuilding key institutions for postconflict recovery has also been underscored (**Addison (2002) and Michailof, Kostner, and Devictor (2002)).** The latter authors propose a framework for stabilization, recovery, and development centered on three areas: (a) rebuilding the state and its key institutions; (b) jump-starting the economy; and (c) addressing urgent needs and reconstructing communities. An important component of this framework is restoring state capacity for macroeconomic management and fiscal operations. They emphasize that postconflict countries require assistance in the areas of budget formulation, execution, and reporting, as well as in design and implementation of critical reforms. In the immediate aftermath of the crisis, there is also an urgent need to strengthen the capacity of the state to generate internal resources through taxation to finance the reconstruction of the economy and ensure delivery of essential services. Thus, an immediate priority in the early postconflict phase should be on rebuilding customs administration and tax systems. They also stress the importance of improving governance and transparency, restoring the capacity for macroeconomic management, and strengthening the judiciary.

Figure 6. Government Spending in Postconflict Countries 1/
(In percent of GDP)

Sources: IMF, *World Economic Outlook* database 2004, national authorities, and IMF staff estimates.

1/ Based on a sample of 10 countries with 11 conflict episodes for wages and salaries, and a sample of 8 countries for defense. See Figure 1 for definition of preconflict, conflict, and postconflict year.

Policies, not just institutions, matter for success in the postconflict period. For example, sound macroeconomic policies are helpful for securing growth and avoiding a relapse into conflict. Fallon and others (forthcoming) analyze the impact of conflict on economic development in 23 conflict-affected countries and conclude that in the post-1990 period, a sound macroeconomic policy stance enabled a faster economic recovery after the conflict. Collier and Hoeffler (2002b) also lend support to this finding. They investigate the impact of aid and policy on the risk of civil war and conclude that policy improvements, in conjunction with increased aid, indirectly affect the growth and structure of income and thereby substantially reduce the risk of conflict. Thus, policy improvements contribute to sustaining peace in postconflict societies.[8]

At the same time, the literature suggests there is a "virtuous circle" between institution building and the implementation of good economic policies. For example, improvements in public expenditure management and tax administration can help establish fiscal discipline.

[8] In another paper, however, Collier and Hoeffler (2000a) argue that social policies should be accorded a higher priority than macroeconomic stabilization in postconflict countries.

This, in turn, can lead to success in achieving macroeconomic stabilization and growth, which in turn provides a more stable and fruitful environment for further institution building.

Strengthening institutions and economic policies is important for reducing the risk of future conflicts. Without appropriate institutions and sound policies, recovery may not be broad-based, high levels of poverty are likely to persist, and the probability of a return to conflict will remain high (Addison, 2003). Collier and Hoeffler (2002b) identify three policy-dependent risks of conflict, the most powerful of which is dependence on natural resource rents. Their analysis indicates that the risk of conflict is highest when natural resource exports constitute 25–30 percent of GDP. They conjecture that dissatisfaction among the population with the way natural resource rents are utilized increases the risk of conflict. In the medium term, the solution is to reduce dependence on these rents through the diversification of the economy and development of other revenue sources, while in the short run, the transparency with which these resources are managed should be improved. In the early stages of the postconflict period, therefore, countries should focus on creating institutions, policies and procedures that ensure transparency in fiscal operations.

Establishing appropriate institutions and good economic policies is also necessary for attracting private investment in postconflict countries. Postconflict countries need strong and sustained increases in private investment to support broad-based economic recovery (Addison, 2003). Catalyzing this private investment requires the concomitant strengthening of institutions and the policy environment.

In sum, the literature suggests that postconflict peace and economic recovery requires improvements in economic policies and institution building in a range of areas. These span from merely establishing the rule of law to restoring capacity for policy formulation and implementation. Even within the area of macroeconomic management, the needs for capacity building could be very extensive. For example, some countries may need to introduce a new currency or establish new institutions, such as a central bank. The need for institution building is most pervasive in scope for countries that are newly formed as a result of conflicts. Others may need assistance with budget formulation, execution, and reporting. Still others may require help in strengthening statistical capacity to assist in macroeconomic management. The focus of this paper will be on institution building in the fiscal area.

IV. Reestablishing Fiscal Management and Institutions in Postconflict Countries

This section discusses the strategies recommended for reestablishing fiscal management and rebuilding institutions in postconflict countries, based on advice to selected countries from the IMF's Fiscal Affairs Department.[9] While the paper attempts to paint a broad picture of

[9] The sample of 14 countries comprises Afghanistan, Bosnia and Herzegovina, Cambodia, Democratic Republic of Congo, East Timor, Federal Republic of Yugoslavia, Georgia, Kosovo, Liberia, Mozambique, Rwanda,

(continued)

the nature of the advice, there were differences in recommendations across countries. This caveat is important, especially when specific measures are discussed. In addition, the description of advice on the design of fiscal institutions does not assess countries' track record in implementing these recommendations, which would involve a more in-depth assessment of developments in each of the countries in the sample.

The analysis below suggests a general strategy for the rebuilding of fiscal institutions in the wake of conflict. The three-step process appears as follows:

- First, create a proper legal framework for fiscal policy;
- Second, establish a central fiscal authority and a mechanism for coordinating foreign assistance; and
- Third, implement necessary changes in tax policies and create simple administrative arrangements in tax and public expenditure management (PEM) that effectively leverage scarce human resources.

The importance of each of these steps differs, depending on whether the country in question existed before the conflict or was newly formed as a result of it. In the case of the former, civil strife has left many of them with some (albeit depleted) administrative and technical capacity, with the degree of damage varying across countries. For these countries, the priority has been to rebuild the capacity for fiscal management. In other preexisting countries, basic institutions, as well as staff, emerged from the conflict largely unscathed, while the legal framework governing fiscal operations was also reasonably sound. Assistance to these countries focused on restarting fiscal operations and improving existing systems. In newly formed countries, there was a need to establish new institutions, as well as to recruit and train staff to undertake fiscal operations. In effect, for newly formed countries, more attention needed to be paid to creation of the legal framework and the establishment of a fiscal authority.

The approach to rebuilding was also shaped by the role of the international community. In some newly formed countries, the UN was responsible for running government operations, which influenced the nature of advice given. In these countries, a special challenge was to ensure that local capacity was in place before power was handed over to national administrators.

The sequencing of the steps generally followed the pattern described above, but not always. For example, while establishing a fiscal authority is a necessary early step in countries where no such institution existed before, setting up of the authority could take some

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Serbia, Sierra Leone, Tajikistan. Some caution should be used in comparing the results from sections III and IV, given the different sample of countries covered in each section.

time. However, certain tax administration procedures needed to be promulgated even if the authority was not fully functional. These included, for example, procedures for collection and payment of border taxes. On the expenditure side, procedures for government payments such as for salaries and purchases of goods and services needed to be put in place urgently and could not await the setting up of a fiscal authority. In some cases, this had to be done before a meaningful budget was established.

The postconflict era provided an opportunity for bold changes. In some cases, there was openness to new approaches that had been previously rejected as being politically, legally, or administratively infeasible. Thus, while administrative capacity may have been depleted, the immediate postconflict period provided an opportunity to put in place major improvements in policies and institutions relative to the preconflict era.

A. Create a Proper Legal Framework for Fiscal Policy

The fiscal operations in any country are generally anchored in two main legal sources: the constitution and tax and budget laws. The constitution generally specifies the division of taxing powers between different levels of government, and between the executive, the legislative, and the judiciary. It also determines the nature of emergency powers available to the executive. Tax laws are critical to make tax policy legally enforceable. They define the powers of the tax administration to collect information about taxpayers, and the administrative actions that can be taken against individuals or entities that evade taxes or accumulate tax arrears. Budget and public financial management laws are also indispensable to ensure that the fiscal authority is vested with the legal authority to control and manage public spending.

The creation of a consolidated package of customs and tax laws, regulations, and directives was often a measure of immediate importance. In countries where preconflict legislation was not reasonably sound, a key objective was to simplify tax legislation and procedures for revenue collection, with a view to making them more transparent and easier to implement and administer. In a number of cases, the complexity of existing legislation made tax laws difficult to implement, especially in light of the limited administrative capacity prevailing in a postconflict environment. For example, in many cases the tax code included a wide variety of duties, tariff rates and special taxes and surcharges. The mismatch between administrative capacity and the complexity of the existing laws and regulations often led to inevitable efficiency losses, mistakes in tax assessments, and difficulties in tax collection. Other problems that the new legislation needed to address were the existence of significant off-budget transactions, lack of clear classification of budgetary spending, and the absence of well-established procedures for managing foreign aid.

Reestablishing the authority of the government to collect taxes and preparing an adequate budget law formed an important component of the strategy to reestablish the rule of law. At the same time, the success or failure of these tax and budget reforms themselves depended heavily on the capacity of the state to reestablish order and the

development of a system of sanctions administered by a judicial system that can penalize those who evade them (Maravall and Przeworski, 2003).

The underlying strategy was to start simple. This implied that budget and tax laws, for example, were made very basic and short (e.g., two to three pages). Over time, these were expanded. This allowed for greater local ownership as the details of these laws were fleshed out over time and capacity improved.

B. Establish a Central Fiscal Authority and a Mechanism for Coordinating Foreign Assistance

Strengthening the central fiscal authority, or establishing one from scratch in new countries, was an essential step in all countries. In effect, newly established countries needed to create a Ministry of Finance; for existing countries, the Ministry of Finance needed to be adequately strengthened so it could perform a number of basic tasks essential for macrofiscal management. Although the precise institutional structure, powers, and responsibilities of newly created institutions varied across countries, based on country-specific circumstances, they shared a number of common objectives. One important objective was to ensure that fiscal decisions were not taken in an ad hoc manner. A second objective was to ensure that government spending was consistent with the government's priorities. A third objective was establishing transparency in fiscal operations. A fourth objective was to ensure a minimum level of revenue collection. Establishing a set of procedures to effectively control government spending or establish accountability was important for efficient service delivery and to assure donors that funds provided for relief and reconstruction were being used as intended. Given the dearth of administrative and technical capacity available within these countries, it was recognized that the institutions should have a simple structure. [10]

The fiscal authority was intended to perform three basic functions. These were:
(i) develop a fiscal strategy and monitor its impact on the economy;
(ii) formulate expenditure policy and execute the budget; and
(iii) formulate tax policy and collect revenues.

The fiscal authority normally consisted of four main operational departments:

a. A *budget department* with the responsibility to coordinate the overall expenditure program and prepare fiscal projections and budget execution reports. With respect to budget formulation, the department issues the budget circular to spending agencies, indicating a budget ceiling and requesting submission of spending plans. These plans are then reviewed for credibility and consistency, and adjusted where agency submissions are incompatible

[10] In a related vein, in the two cases where issues of fiscal federalism were particularly important, it was argued that fiscal decentralization would need to wait, as the necessary institutions were not yet in place to ensure that this decentralization would be consistent with sound macrofiscal management of general government operations.

with aggregate budgetary ceilings or policy priorities. In the area of tax policy, the budget department consults with its counterparts in tax administration to prepare projections for revenues, and assesses the impact of different tax policy changes on these receipts. This information, along with fiscal projections and budget execution reports, is then provided to the appropriate decision-making authority, so as to enable it to make fiscal policy decisions in an orderly and systematic fashion.

b. A *treasury department* responsible for controlling spending and ensuring that it is properly accounted for. The department performs the dual functions of providing spending authorization to spending agencies (based on the approved budget) and making sure that spending is properly recorded. It also is tasked with oversight of the movement of collected government revenues into treasury bank accounts, the rationalization of government banking arrangements to promote transparent recording of transactions, and workable strategies for cash management. The department also prepares periodic expenditure reports to enable the spending agencies and the budget department to effectively monitor spending during the course of the year.

c. Separate *customs and domestic revenue administration departments* responsible for implementing tax policy and collecting tax revenues. In newly created countries, tax policy options were constrained by administrative capacity and, in most cases, it was decided that tax policy and administration should be under unified management. Thus, these departments were also entrusted with responsibility for tax policy. One issue that often arose in this context was whether customs and domestic tax administration should be merged in order to simplify administration. The modest amount of resources expected from domestic taxes also was cited by the authorities, in some cases, as an argument in favor of unifying administration. On the other hand, the procedures for collecting these revenues differ substantially; in light of this, reports argued for establishing separate customs and domestic tax administration departments, with the former entrusted with the responsibility for collecting trade taxes.

In some cases a macrofiscal unit was also recommended to help support policy formulation. In four countries this unit was recommended to (i) prepare a medium-term expenditure framework; (ii) conduct debt sustainability analysis; (iii) analyze tax policy issues; and (iv) assess structural fiscal issues such as pension reform.

A mechanism was needed in many countries to facilitate coordination of donor funds. In some instances, there were no procedural arrangements for the use of foreign aid, and insufficient coordination between donor agencies and the Ministry of Finance. In these cases, there was often a disconnect between expenditure needs and budgetary outlays. Better coordination was thus seen as essential for both donors and recipient countries. From the perspective of the donors, information on activities of other donors in specific areas was useful in framing their own assistance strategies and to avoid duplication. For the recipients, such a mechanism provided the spending agencies with information on activities of donors in their area of competence, and thus helped in framing their plans for spending financed from domestic resources. In addition, donor-financed projects also gave rise to future recurrent

spending requirements, which needed to be incorporated in future spending plans. In some countries, a separate unit was set up to coordinate with donors, often as part of the Ministry of Finance or its equivalent institution. In other cases, however, a multi-donor trust fund was set up that provided the coordination function.

C. Implement Necessary Changes in Tax Policies and Create Simple Administrative Arrangements that Effectively Leverage Scarce Human Resources

Under this last step, a number of actions were taken to simultaneously change tax policies, strengthen tax administration, and reestablish expenditure management and control. In some cases, some of these actions were taken at the time that enabling laws were passed (see discussion above).

Policies to mobilize revenues

Mobilizing domestic revenues presented a difficult challenge in the postconflict era. The task was complicated in some countries where the tax base was limited in the immediate aftermath of the conflict, owing to the destruction and disruption of economic activity.

The immediate objective of tax policy in postconflict countries was to raise revenue quickly to finance the most urgent government activities (e.g., paying civil servants and delivering basic public services) and address macroeconomic imbalances. The longer-term objective was to rehabilitate the tax system, so as to mobilize revenues sufficient to cover a significant portion of public expenditures. In general, tax policy proposals were consistent with the objective of establishing a fair, transparent, and efficient tax system.[11] However, the strategy for revenue generation had to take into account the state of existing institutions and capacity available to implement policies, as well as tax instruments in place at the time the conflict ended. In addition, there was often a trade-off between short-term revenue mobilization efforts and tax efficiency. In some instances, taxes that were less than desirable from an efficiency point of view were recommended, given the limited options available for generating revenues.

A major challenge for some countries was that a large share of the tax base—in particular, incomes of those working for international institutions—was exempt from taxation. Many postconflict countries experienced a large influx of expatriates in connection with relief and reconstruction work. In general, these incomes were exempt from taxation. The differential treatment of expatriates risked the creation of a culture of tax exemptions, and made it more difficult to implement a simple tax system where all taxpayers faced a level playing field.

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[11] The objective was to gradually establish a tax system that minimizes distortions and is generally perceived as being fair. To this end, the tax system should (i) minimize interference with individual consumption, saving, investment and production decisions; (ii) be relatively simple, transparent, and rules-based, which facilitates compliance, makes tax administration easier, and reduces corruption; and (iii) be stable and predictable, so that economic agents can avoid the harmful effects of uncertainty.

In existing countries, the approach to revenue mobilization was dictated by the tax system already in place and the administrative and technical capacity available at the time. The approach was to rely as much as possible on the existing system to raise revenues in the short run, and delay major policy initiatives until sufficient capacity had been rebuilt. In some countries, major sources of revenues remained largely unaffected by the conflict or were quickly rehabilitated after the cessation of hostilities. In those countries, greater attention was paid in the early postconflict period on restoring capacity in revenue administration. Tax instruments were left largely intact, except for modifications to make them simpler, more transparent and easier to implement. Where conflict had so severely damaged capacity that the existing system could not be implemented effectively, the approach was to simplify and streamline the system by reducing the number of taxes, harmonizing rates, and reducing exemptions. In some countries, capacity was so depleted after the conflict that only border taxes provided a significant source of revenue, even though the existing tax system in the country—on paper—was quite satisfactory.

In newly created countries without a preexisting tax system, revenue mobilization relied heavily on indirect taxes. In the initial stages, the emphasis was on international trade taxes (including sales taxes imposed on imports). In one country, for example, these accounted for up to 70 percent of total tax revenue. These were relatively easy to monitor and collect, given that there were only a few border points through which international trade could be conducted. In view of the limited capacity available, the structure of customs tariffs was kept simple, and in some cases consisted of one single rate with limited exemptions. This represented a radical departure from existing practices for some countries; in one case, for example, rates ranged from 7 to 150 percent and were allocated across 888 tariff headings. A sales and excise tax on imports was also introduced, again with a simplified structure. In the initial postconflict period, with limited domestic production, imports accounted for a very high proportion of consumption; as such, a sales tax on imports effectively constituted a domestic consumption tax.

Some countries also introduced a tax on major exports. In cases where one or two products constituted the bulk of the exports whose production was quickly restored following the end of the conflict (e.g., coffee), an export tax was seen as another area for revenue mobilization in the early postconflict period. From an efficiency standpoint, these taxes leave much to be desired, as they divert resources away from their most productive uses. In addition, by retarding investment in export sectors, these taxes may contribute to future difficulties in the balance of payments. To avoid these distortions, an income tax—including on the incomes of exporters—could be imposed, instead of a tax on exports per se. In some postconflict countries, however, this was not a viable option for raising large amount of revenue, given the complexity of administering this tax. In this light, a tax on exports was seen as a necessary evil, albeit one that would, over the longer term, be phased out as other sources of revenue became available.

Taxes on selected services with easy tax handles such as restaurants, hotels, and car rentals were recommended. A broader tax on domestically produced goods was considered

to be unrealistic in some countries, given the widespread destruction caused by the conflict and limited administrative capacity. At the same time, the large influx of expatriates led to a surge in spending at a small number of hotels and restaurants, providing an easily identifiable tax base that could be exploited in a simple and straightforward manner. The fact that the burden of these taxes would fall on these expatriates also made them politically attractive. In the initial stages, this tax was to be confined to a few large business organizations. As administrative capability developed, the coverage of the tax was intended to be broadened to cover areas such as professional, legal, and accounting services.

In most countries, some form of income taxation was also proposed. This was deemed necessary for two reasons. First, in some countries, the income tax, in some form or another, existed in the preconflict period. Thus, although the tax was complex to administer, there was previous experience to draw on while revitalizing this source of revenue. Second, policy makers were concerned that if an income tax of some sort was not introduced from the outset, it would be politically difficult to do so later on. In all cases, the form of taxation proposed had to take into account the available administrative and technical capacity countries, as well as the loss of some of the tax base owing to the adverse effects of conflict on economic activity and the stock of private sector capital. It was generally recommended that tax rates be harmonized and reduced to encourage compliance, and that the tax base be broadened by limiting exemptions. In one country, for example, it was advised that the top marginal tax rate be trimmed from 60 percent to 25 percent. In another country, it was suggested that most of the 27 separate sources of income exempted from taxation (including pensions, interest, and sale from agricultural products) be brought back into the tax net.[12]

A particularly attractive form of income taxation in the early postconflict period was a flat withholding tax on wages. This had two advantages. First, the administration of the tax was relatively straightforward. Thus, the tax would not affect the large majority of the population, thereby reducing resistance to this measure. Second, it would be applied, initially, to relatively high income earners. For example, in one country the proposed withholding system would only apply to employees earning more than two times the average wage. In addition, in many cases, there was some sort of a tax on wages before the conflict began, so that reintroducing it in the early stages of the postconflict period was deemed appropriate.

Measures were also suggested for taxing business income. In the initial stages, a presumptive tax on income was recommended for small businesses. For example, tax assessments would be based on the type of product sold, square footage of the enterprise, or a rough estimate of turnover. While the expected revenue yield from such a tax was not

[12] In one case, however, it was recognized that the existing income tax system was insufficiently progressive, as the level of income exempted from the tax was very modest (13 percent of per capita GDP). The fact that the top marginal tax rate (34 percent) did not apply until incomes reached 10 times per capita income also reduced the progressivity of the tax.

projected to be significant, it was expected that in many countries small businesses would quickly become a visibly active part of the economy. As such, there was concern that exempting them from taxation would promote a culture of tax non-compliance. A presumptive tax was considered appropriate at this stage, as small businesses were not expected to be able to maintain reliable accounts, and audit capacity in revenue administration was weak. For large unincorporated businesses, a similar tax was proposed.

It was recommended that corporate income taxes be simplified. In some cases, a profit tax existed, but yielded paltry revenues on account of excessively generous tax incentives. In one country, for example, the profit tax yielded less than ½ percentage point of GDP, with incentives eroding the yield in half. In this case, it was suggested that tax incentives be replaced with a simple—and less generous—tax credit for investment in fixed assets. In another country, the corporate income tax rate was progressive with rates varying from 20 to 50 percent. In this case, the recommendation was to implement a flat income tax on all business income of 30 percent. In another country, it was suggested that investment incentives be streamlined and made more transparent.

Strengthening revenue administration

In newly created countries, a new and independent tax administration needed to be created. In existing countries, some tax administration capacity was preserved, but at a much lower level than before the conflict.

(a) *Reestablishing basic tax administration infrastructure*

In some cases, basic office equipment was seen as the first priority. In all cases there was seen to be a need for an improved information and technology system. Given limited capacity, it was often recommended that the process of modernization begin with a few selected tax offices or departments.

(b) Registration and taxpayer identification

In newly formed countries, legislation was needed to require individuals or companies engaged in commercial activities to register with the authorities. In countries where a taxpayer register existed, this was used as the starting point. In some cases, however, conflict resulted in important changes in the nature and structure of activities of these taxpayers, necessitating a rebuilding of the taxpayer master file. Steps were also needed to ensure that all potential new taxpayers were registered. Therefore, registration-check audits were recommended, along with an appropriate penalty regime for non-registerers.

It was also recommended that all registered taxpayers be assigned a unique taxpayer identification number (TIN). This same number would be used in filing their different taxes (e.g., VAT, corporate income tax). The TIN was expected to (i) assist the revenue administration in crosschecking information on taxpayer compliance and (ii) facilitate computerization of tax administration at a later stage.

(c) Introduction of a self-assessment system and simplification of tax administration procedures

Establishing simple procedures for filing and payment of taxes or simplification of existing procedures was also needed. In many countries, the existing system required that taxes be assessed by tax officials. This complicated tax administration and provided ample opportunities for corruption. Therefore, for many countries it was suggested that they simplify tax procedures by introducing a system of self-assessment. In a similar vein, it was advised that countries introduce risk-based (selective) systems of customs inspections, rather than the 100 percent inspection rule that overemployed scarce customs staff. Tax return forms needed to be simplified to enable taxpayers to calculate and report their tax liabilities easily. Countries were also advised to undertake public information campaigns to inform and educate taxpayers on procedures for completing their tax returns and calculating their tax liabilities. The procedures for filing and payment requirements for each tax would also need to be clarified.

(d) Creation of a Large Taxpayers Unit (LTU)

A LTU, focusing on taxpayers accounting for a significant majority (usually 60 to 80 percent) of the tax revenues, was recommended for many countries.[13] In the initial phases of the postconflict period, enforcing compliance with basic tax regulations was a major challenge in mobilizing domestic tax revenues. Scarce administrative capacity could best be used, it was argued, by concentrating these resources on the relatively small number of taxpayers accounting for the lion's share of the tax take. Focusing audit activity on these firms in the LTU, for example, was seen as more effective in helping raise compliance (and thus revenue) than more generalized approaches applying to all taxpayers. Moreover, it was also envisaged that setting up LTUs would contribute to longer-term development of tax administration by providing a pilot of best practices with respect to auditing, appropriate procedures for assessment, processing, and collection of taxes, as well as development of an information management system. Setting up the LTUs in a postconflict environment, however, was not an easy task. First, they required a qualified pool of tax inspectors who could effectively perform the audit function. This required a high degree of preparation and training. Second, in postconflict countries, the disruption of economic activity during the conflict made it difficult to identify large taxpayers and to assess the impact of the new legislation affecting them.

(e) Developing an audit capacity

The move to a self-assessed tax system required the development of a comprehensive program of audit. In many cases audit units did not exist or were severely understaffed. For example, in one of the most extreme cases, 18 employees had to audit over 800 taxpayers.

[13] In one country, the largest 150 taxpayers accounted for 80 percent of revenues.

An effective audit system required elaboration of rules for assessment of risk to identify which taxpayers should be audited. Methods for conducting audits also needed to be specified. In countries where an audit system existed prior to the conflict, the strategy was to revitalize the system through training of auditors and establishing an audit strategy. In countries where no such system existed before the conflict, in the initial phases, audits were confined to activities such as registration checks, comparing wage records with remittance of wage withholding tax by employers, checking the books of large hotels and restaurants, and checking on participation by small/medium businesses in the presumptive tax arrangements. These activities provided on-the-job training for audit personnel, while also serving to educate taxpayers regarding the new tax system. As capacity developed, audit activity gradually expanded to cover more areas.

Reestablishing expenditure management and control

Upon entering the postconflict era, most countries lacked a well functioning PEM system. As such, implementing such a system was seen as a cornerstone of the reconstruction strategy, given the need to both increase spending to meet social needs while addressing macroeconomic imbalances. An additional issue was that most postconflict countries received a substantial amount of foreign assistance for humanitarian and reconstruction purposes. Thus, accurate and meaningful information on government spending dictated that donor funds should flow through the government expenditure system. However, donors would only agree to this if transparent and accountable procedures for executing public spending were in place.

Ensuring that the budget was executed—and not just that total expenditures were under control—was also a central challenge in the postconflict era. In some countries, budgets were not being executed, given the inexperience of the government. This implied that some critical programs for reconstruction were not being implemented.

Some aspects of the PEM system were accorded greater priority than others in the early postconflict period. Two areas received special attention during this phase: (i) ensuring that the central authority had control over all revenues and expenditures; and (ii) establishing a simple accounting and reporting framework. In countries where a system was already in place, the approach was to strengthen existing systems. In other countries, the emphasis was on establishing rudimentary systems that were capable of timely and transparent formulation and reporting of expenditure and revenues at a fairly aggregate level.[14]

In some cases, training was seen as an urgent need in the short run. While training was also envisaged over the long term (see below), in three countries, crash-course training in

[14] In one instance, for example, it was recommended that a rudimentary budgetary circular be developed that would help provide guidance to line ministries on their request for personnel.

basic accounting, financial management, and computer operations was seen as critical for getting the PEM system up and running.

To achieve the first objective, it was necessary for the Ministry of Finance to establish control over all government receipts and expenditures. In some countries, a significant portion of revenue and spending was not flowing through the treasury during the conflict period. Thus, government accounts presented only a partial picture of the fiscal situation. With a return to more normal conditions, an attempt was made to reduce these fiscal operations conducted through extrabudgetary channels by integrating all government revenues and expenditures into the treasury.[15] Another complicating factor was that in the initial postconflict phase, a large part of both recurrent and capital expenditure was financed by donors. It was advised that all donor funds should flow through the government's PEM system, and that donors avoid establishing competing or conflicting aid disbursement and management mechanisms. At the same time, it was recognized that donors would, in many cases, oppose this recommendation, given their intent to control the outlays they financed. In some cases, however, it appeared that donors would be open to at least incorporating their support for recurrent outlays into the budget.

Improved information on government financial flows was also seen as important for ensuring that all government revenues and spending were captured in a comprehensive fashion. In particular, comprehensive information on government accounts in the banking sector is needed to help ascertain the accuracy of data on fiscal outturns based on accounting data. To improve these government financing data and simplify the process of collecting this information, it was advised that countries implement a Treasury Single Account (TSA). It was envisaged that all government revenues and expenditures would flow through the TSA. The TSA would also allow for better cash management by consolidating cash resources in a single account.

In some countries, such an account already existed, but was not comprehensive. In such situations the approach was to gradually integrate revenue and expenditure flows that were outside of the TSA. In some cases, spending agencies held accounts in commercial banks and the approach was to gradually consolidate these accounts in the TSA.[16]

The recommended route for establishing the second objective—a meaningful accounting framework—varied according to country circumstances. In some countries, the existing accounting structure was reasonably compatible with acceptable international standards, and thus the existing system could be used in the initial phases of the postconflict

[15] Lags in fiscal reporting were also a concern, including in the postconflict period. For example, in one country, for a period of over six months the treasury did not receive any cash transfers from about half of the provincial tax-collecting agencies.

[16] In at least one case, there were literally hundreds of different bank accounts.

period. However, in others this was not the case, and in newly created countries, sometimes no accounting structure existed. There was thus the need to introduce a simple classification system based on administrative units and core functions (e.g., health, education, and security), a few broad economic items (such as wages and salaries, goods and services, and capital expenditures), and a funds/projects classification to facilitate the tracking of funds from different donors. Such a classification provided for streamlining and simplifying budget documentation and thereby promoted fiscal transparency. In addition, a unified reporting format was also developed in these countries to facilitate timely and transparent reporting of fiscal operations both to the government and donors.

Following the establishment of a basic PEM system, additional steps were recommended to strengthen budget execution. Improved cash flow planning was seen as an essential component in improving budget management. A system to control spending at the commitment stage was also advocated; in cases where commitment control existed, a strengthening of the system was recommended. In some countries, it was also suggested that a basic computerized system be set up to process checks, record information, and produce timely fiscal reports. In other cases, computerization was only viewed as feasible for central offices, with branch offices continuing to use manual procedures.[17]

Further improvements in expenditure procedures were also advocated, but for the latter phases of the reconstruction process. These involved the reinforcement of the administrative and technical capacities of the line ministries and the implementation of more advanced training programs, usually with donor financing. Other priorities included the drafting of manuals on budget preparation and expenditure authorization procedures. Over time, it was also envisaged that a clear set of procedures for the monitoring and control of spending would also be developed and disseminated to all relevant government agencies.

A strengthening of macro-fiscal analysis and audit capacity was also recommended. Setting up a macro-fiscal analysis unit was recommended to provide advice on general fiscal policy issues and the preparation of the budget. More specifically, it would assist the Ministry of Finance in preparing revenue forecasts for the budget year and fiscal policy scenarios. At the same time, gradual development and strengthening of auditing capacity, together with the establishment of a code of fiscal conduct, were recommended for limiting corruption, waste, and misappropriation of public resources.

V. SUMMARY AND CONCLUSIONS

It is widely recognized that economic recovery is an essential ingredient for building and sustaining peace in postconflict countries. Macroeconomic conditions in these countries were adverse before conflict began and deteriorated further as a result of it. Real

[17] In most countries, full computerization of the treasury ledger and payments system was viewed as a medium-term (rather than short-term) objective.

incomes fell during the conflict, fiscal deficits widened, and inflation skyrocketed. Moreover, the composition of spending also worsened due to the conflict. Addressing these macroeconomic imbalances was important for jump-starting the economy and laying the basis for sustained growth.

Economic recovery required supporting institutions and policies, many of which were lacking in postconflict countries. In many countries, institutions were either non-existent when the conflict ended, or were severely damaged by the conflict. Capacity for policy formulation was also often weak. Therefore, establishing and strengthening key institutions was an important early step in many of these countries.

Building fiscal institutions in postconflict countries essentially entails a three-step process. These are: creating a legal framework for fiscal management; establishing and strengthening the fiscal authority; and designing appropriate policies while simultaneously strengthening revenue administration and public expenditure management. The sequencing of the steps differed across countries, depending on country-specific circumstances. The ultimate aim, however, was always the same—to make fiscal policy and fiscal management effective and transparent.

Four objectives guided institution building in the fiscal area: avoiding ad hoc decision making; ensuring that spending patterns reflected established priorities; promoting transparency in fiscal operations; and ensuring a minimum level of revenue collection. A first step was usually to review existing legislation, with a view to simplifying tax laws and administrative procedures. The next step was to strengthen the central fiscal authority or set one up if none existed. Such an authority usually consisted of four departments: a budget department, a treasury department and separate departments for tax and customs administrations. In some countries there was also a need to establish mechanisms for coordinating donor assistance.

The Fund's advice was in many ways similar to what it recommends in countries without conflicts, but with important nuances to reflect the realities of postconflict countries. For example, recommendations to introduce simple income taxes based on withholding of wages, to strengthen auditing, to create Large Taxpayer Units, and improve budget classification are frequently recommended in the Fund's advice for developing countries. At the same time, this advice was tailored to the circumstances of postconflict countries. For example, with respect to tax policy, there was generally more openness to policies that were not first-best from an efficiency point of view (e.g., export taxes), given urgent needs to generate revenue. In a similar vein, proposals to improve tax administration—for example, by strengthening auditing—focused on very rudimentary aspects of these procedures (e.g., registration checks). Similarly, on the expenditure side, the focus was to implement very simple systems (e.g., budget classifications under very broad categories of outlays) that would, eventually, need to be improved.

The sequencing of reforms was also different for postconflict countries. The timetable for implementing reforms that should be part and parcel of a good system of fiscal

management—for example, an adequate medium-term expenditure framework—was also much longer. In general, recommendations had to focus on a large number of intermediate measures over the short term that could gradually move budgetary practices from a crisis mode (e.g., where budgets were implemented on a three-month basis) to a more normal state of affairs.

In framing these short-term policies and arrangements, care was taken to ensure that they did not pose an insurmountable obstacle for the eventual transformation to a modern fiscal management system. Looking forward, additional research is needed to ascertain the track record of countries in implementing these recommendations and what progress has been made toward more permanent improvements in the operations of fiscal institutions.

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List of Countries and Conflict Years 1/

	Country	Preconflict 2/	Conflict 2/	Post conflict 2/
1	Albania	1999	2000	2002
2	Congo, Dem. Rep. of	1997	2000	2001
3	Congo, Republic of	1992	1993	1996
4	Congo, Republic of	1997	1998	2001
5	Croatia	1992	1995	1999
6	Eritrea	1997	2000	2002
7	Ethiopia	1997/98	2000/01	2002/03
8	Georgia	1991	1994	1998
9	Guinea-Bissau	1997	1999	2001
10	Lebanon	1974	1990	1994
11	Mozambique	1980	1992	1996
12	Nicaragua	1979	1990	1994
13	Tajikistan	1991	1995	1999
14	Yemen, Republic of	1993	1994	1998

Source: SIPRI Yearbooks.

1/ The SIPRI Yearbook define armed conflict as "prolonged combat "between the military forces of two or more governments, or of one government and at least one organized armed group, incurring the battle related deaths of at least 1000 people during the conflict period.

2/ "Preconflict year" refers to the last year before the beginning of a conflict; "conflict year" referes to the last year of a conflict; and "postconflict year" refers to four years after the end of the conflict or the latest year for which data is available.