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Preface

The International Monetary Fund's assistance to postconflict countries consists of three main elements: (i) technical assistance to rebuild capacity in key economic institutions; (ii) policy advice; and (iii) financial and technical assistance in mobilizing donor support. The objective is to lay the basis for sustainable growth through institutional development and by addressing macroeconomic imbalances. Typically, IMF assistance to postconflict countries is provided in the context of internationally coordinated efforts with other multilateral agencies and bilateral donors.

This paper was prepared for a seminar of the IMF Executive Board on technical assistance in fiscal and monetary areas provided by the Fund to postconflict countries. It discusses experiences in reestablishing fiscal management in those countries; reviews the challenges in rebuilding fiscal institutions based on experiences in 14 postconflict countries; and identifies key priorities in the fiscal area following the cessation of hostilities.

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I Introduction

The proliferation of violent conflicts over the past two decades has taken a heavy toll on life and property. The effects of conflict have often spilled across national boundaries through the disruption of economic activity or the influx of refugees, to cite just two examples. Furthermore, countries in conflict have a high tendency to relapse into subsequent conflicts (Bigombe, Collier, and Sambanis, 2000). As such, the legacy of conflict—and its adverse effects on socioeconomic 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, on its "institutions." There are at least five market-supporting institutions: property rights, regulatory, macroeconomic stabilization, social insurance, and conflict management institutions (Rodrik, 2000). Conflicts can damage one or more of these institutions.

Recent empirical evidence shows a strong relationship between these market-supporting institutions and economic growth (North, 1990; Olson, 1993; Rodrik, Subramanian, and Trebbi, 2002; Acemoglu and others, 2003; and Rodrik, 2004). Hence, institutional reconstruction and development is one of the key priorities in the postconflict period. 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. It examines the challenges and experiences in building fiscal institutions and capacity in postconflict countries and territories, beginning with a review of the literature on this topic in this introductory chapter. Chapter II discusses the nature and form of technical assistance to postconflict countries and territories from the International Monetary Fund through its Fiscal Affairs Department, highlighting the importance of donor coordination. Chapter III then provides an overview of the macroeconomic and fiscal consequences of conflict by examining changes in key macroeconomic variables in a subsample of those postconflict countries immediately before the conflict, at the end of the conflict, and for the latest year for which data are available. Chapter IV reviews experiences in reestablishing fiscal management in postconflict countries and analyzes key priorities for rebuilding fiscal institutions in the early postconflict period. Chapter V then presents case studies on the implementation of IMF technical assistance in fiscal areas in six countries: the Islamic Republic of Afghanistan, Bosnia and Herzegovina, the Democratic Republic of the Congo, Lebanon, Mozambique, and Timor-Leste. The final two chapters present lessons drawn from the IMF's involvement in postconflict countries and summarize the paper's conclusions.

Review of the Literature

The literature on postconflict assistance highlights the important role of rebuilding institutions to facilitate the resumption of economic activity and the effective absorption and management of aid inflows. The pattern in many postconflict countries has been for aid to surge immediately after the cessation of hostilities and gradually taper off thereafter. Collier and Hoeffler (2002a) argue that this pattern of aid flows leaves much to be desired, as the capacity of these countries to absorb assistance is rather low in the early postconflict period. This is partly due to weak political and administrative capacity.[1]

A framework for stabilization, recovery, and development should center on three pillars: (i) rebuilding the state and its key institutions; (ii) jumpstarting the economy; and (iii) addressing urgent needs and reconstructing communities (Addison, 2003; and Michailof, Kostner, and Devictor, 2002). An important component of this framework is restoring state capacity for macroeconomic management and fiscal operations. Postconflict countries require assistance in budget formulation, execution, and reporting, as well as in the 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

[1]A recent paper by Suhrke, Villanger, and Woodward (2004) challenges these findings.

the reconstruction of the economy and ensure delivery of essential services. Thus, an immediate priority in the early postconflict phase should be rebuilding revenue administration and systems.

Sound policies are also important for success in the postconflict period. For example, sound macroeconomic policies help sustain a recovery of growth and avoid a relapse into conflict. Staines (2004) analyzes the impact of conflict on economic development in 23 conflict-affected countries and concludes that in the post-1990 period, a sound macroeconomic policy stance enabled a faster economic recovery after the conflict.[2]

At the same time, there is a "virtuous circle" between building institutions and implementing good economic policies (Addison, 2003). For example, improvements in public expenditure management and tax administration help establish fiscal discipline. This, in turn, contributes to success in achieving macroeconomic stabilization and growth, thereby providing a more stable and fruitful environment for further institution building.

Strengthening institutions and economic policies reduces 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).[3]

Establishing effective institutions and economic policies is also necessary for attracting private investment in postconflict countries. These nations 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, postconflict peace and economic recovery require improvements in economic policies and institution building in a range of areas. These extend from merely establishing the rule of law to restoring the capacity for policy formulation and implementation. Even within the area of macroeconomic management, the needs for building capacity can be extensive. For example, some countries may need to introduce a new currency or establish new institutions, such as a central bank. The need for building institutions 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 is on institution building in the fiscal area.

[2]Collier and Hoeffler (2002b) also lend support to this finding.

[3]Collier and Hoeffler (2002b) identify three structural characteristics that increase the risk 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 to 30 percent of GDP.