

INTERNATIONAL MONETARY FUND

Rebuilding Fiscal Institutions in Post-Conflict Countries

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List of Acronyms

ACI	Armed Conflict and Intervention project
EU	European Union
CIDA	Canadian International Development Agency
CFA	Central Fiscal Authority
DFID	Department for International Development
DRC	Democratic Republic of the Congo
FAD	Fiscal Affairs Department of the International Monetary Fund
FRY	Federal Republic of Yugoslavia
GDP	Gross Domestic Product
IMF	International Monetary Fund
LEG	Legal Department of the International Monetary Fund
LTU	Large Taxpayers Unit
PEM	Public Expenditure Management
PER	Public Expenditure Review
SIPRI	Stockholm International Peace Research Institute
SMP	Staff-monitored program
TA	Technical assistance
TIN	Taxpayer Identification Number
TSA	Treasury Single Account
UNMIK	United Nations Interim Administration Mission in Kosovo
USAID	United States Agency for International Development
VAT	Value-added tax

EXECUTIVE SUMMARY

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

Four objectives have guided FAD’s advice to post-conflict countries on building or re-establishing their fiscal institutions: (i) avoiding ad hoc decision making; (ii) promoting transparency in fiscal operations; (iii) ensuring a minimum level of revenue collection; and (iv) ensuring that spending patterns reflect government priorities. A first step was usually to review existing legislation, with a view to simplifying tax laws and administrative procedures, or establishing new ones if existing laws and procedures were viewed as inadequate. The next step was to strengthen the central fiscal authority (CFA), 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, an explicit mechanism for coordinating donor assistance was also established.

The Fiscal Affairs Department (FAD)’s advice was in many ways similar to what it recommends in countries without conflicts, but with important nuances to reflect the realities of the post-conflict environment. For example, recommendations to introduce simple income taxes based on withholding of wages, create large taxpayer units (LTUs), and improve budget classification are frequently part of FAD’s advice to developing countries. At the same time, this advice was tailored to the circumstances of post-conflict 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 the urgent need to generate revenue. In a similar vein, proposals to improve tax administration focused on very basic aspects of these procedures (e.g., procedures for filing and payment of taxes and registration checks). Similarly, on the expenditure side, the focus was to implement simplified systems (e.g., budget classifications under very broad categories of outlays) to be refined at a later stage. In some cases, the adoption of the first post-conflict budget—sometimes a transitional one—became an urgent priority, unlike in the case of most other countries receiving IMF advice.

The sequencing of reforms was also different in post-conflict countries. The timetable for implementing reforms that are 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.

A number of lessons can be drawn from FAD's involvement in rebuilding fiscal institutions in post-conflict situations. From the standpoint of the design of this advice, six major lessons emerge. First, framing an overall technical assistance (TA) strategy at the outset is crucial for sequencing as well as coordinating TA among the multiple providers that are usually active in post-conflict countries. Second, there might not be a substitute for posting long-term advisors in the early post-conflict phase in light of weak capacity. Third, the initial strategy should comprise simple steps and procedures. Fourth, in some instances, policy recommendations for the initial post-conflict period may not be optimal from an efficiency point of view, but may still be the best possible alternatives in light of limited technical and administrative capacity. Fifth, while the need for simplicity and administrative ease in designing short-term laws and procedures is paramount, care has to be taken to ensure that where possible short-term policies should be consistent with the long-term goal of moving to a modern fiscal system. And sixth, issues related to fiscal decentralization can pose a challenge to fiscal management in some cases. With respect to implementation, there are six central lessons. First, the overall strategy designed at the outset should be flexible enough to respond to changing circumstances on the ground. Second, the level of ownership and commitment of the authorities has an important bearing on the pace of reforms. Third, effective donor coordination is also important for successful implementation of reforms; there is scope for improvement in this area. Fourth, appropriate conditionality in Fund-supported programs can facilitate implementation of reforms. Fifth, development of local capacity has taken longer than envisaged; more attention needs to be given to this issue. And finally, the pace of implementation of reforms can be substantially affected by the security situation.

I. INTRODUCTION

1. **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.¹ As such, the legacy of conflict—and its adverse effects for socio-economic development—have been difficult for many countries to escape.

2. **One of the most destructive effects of conflicts is the damage they inflict on the social, economic, legal, and political organization of a society, i.e., 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, 2000). 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, institutional reconstruction and development is one of the key priorities in the post-conflict 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.

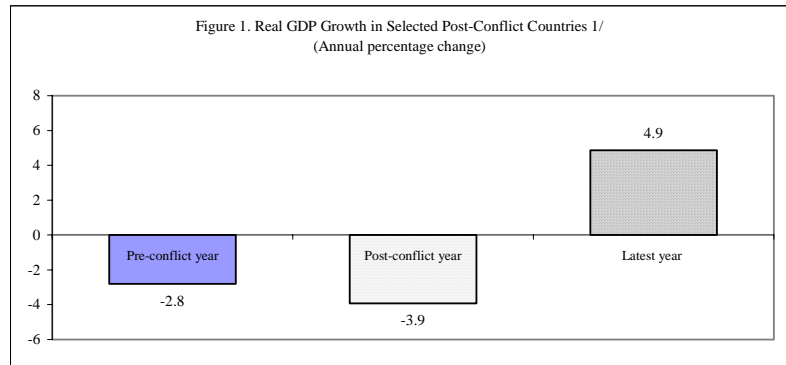
3. **This paper focuses on a small but important set of economic institutions, namely, those in the fiscal area.** The paper reviews the challenges and experiences in institution and capacity building in the fiscal area in post-conflict countries. The paper is organized as follows: Section II provides an overview of the macroeconomic and fiscal consequences of conflict by examining changes in key macroeconomic variables immediately before the conflict, at the end of the conflict, and for the latest year available in a sample of post-conflict countries; Section III reviews the literature on some of the key aspects of rebuilding economic institutions in post-conflict environments; Section IV discusses the nature and form of FAD TA to post-conflict countries, highlighting the importance of donor coordination; Section V discusses experiences in reestablishing fiscal management in post-conflict countries and analyzes, on the basis of the advice provided by FAD, key priorities for rebuilding fiscal institutions in the early post-conflict period; and Section VI presents lessons drawn from FAD’s involvement in post-conflict countries. The accompanying background paper presents case studies on the experience in implementing FAD technical assistance advice in six countries (Afghanistan, Bosnia and Herzegovina, Democratic Republic of the Congo (DRC), Lebanon, Mozambique, and Timor-Leste).

¹ Bigombe, Collier, and Sambanis (2000).

II. MACROECONOMIC AND FISCAL SETTING IN POST-CONFLICT COUNTRIES

4. The challenges facing post-conflict countries can be gauged by economic conditions confronting them in the aftermath of a conflict.²

Figures 1-6 present information on macroeconomic and fiscal conditions in the year before the start of the conflict, at the end of the conflict, and for the latest year available.^{3 4 5} The data presented cover 17 countries and conflict episodes which spanned the period 1990–2003. These figures only include countries that existed before the conflict, and thus do not cover countries or entities that were born out of these conflicts (e.g., Timor-Leste and Kosovo).



Sources: IMF, *World Economic Outlook* database 2004; and World Bank, *World Development Indicators* database 1/ Based on a sample of 13 countries. "Pre-conflict year" refers to the year before the beginning of a conflict, except for Albania and Croatia where it refers to 2 years before the conflict; "Post-conflict year" refers to the year before the first FAD TA mission during the conflict or immediately after the conflict; "Latest year" refers to the latest year for which data are available.

5. Macroeconomic imbalances—already severe at the onset of the conflict—were generally exacerbated by the hostilities. On average, real gross domestic product (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 Both real GDP as well as real per capita GDP were below their pre-conflict levels when the first FAD TA mission took

² For a more comprehensive study of the relationship between conflict episodes and economic performance, see Staines (2004). The author documents how recent conflicts have become shorter but have resulted in more severe contractions in economic activity, followed by a stronger recovery of growth.

³ This analysis is based on a subset of 17 of the 28 post-conflict countries identified in Section IV to the extent that data are available. These 17 countries or entities are also analyzed in Section V. They comprise Afghanistan, Albania, Bosnia and Herzegovina, Cambodia, Croatia, Democratic Republic of the Congo, Kosovo, Lebanon, Liberia, Mozambique, Rwanda, Serbia and Montenegro, Sierra Leone, Tajikistan, Timor-Leste, Yemen, and West Bank and Gaza.

⁴ In Figures 1–6, "post-conflict year" refers to the year before the first FAD TA mission was fielded. This year provides the backdrop for the macroeconomic situation against which post-conflict TA was provided. In most cases, this is the last year of the conflict (as defined by the Stockholm International Peace Research Institute (SIPRI)) or later. However, in 4 (of the 17) countries in the sample, the first mission took place during the conflict.

⁵ The analysis presented in this section should be interpreted with caution. The evolution of the macroeconomic variables over the period covered by the analysis is influenced by a host of factors other than the conflict. 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).

place. Inflation, already at high levels before the onset of hostilities, increased further during the conflict episode (Figure 3).

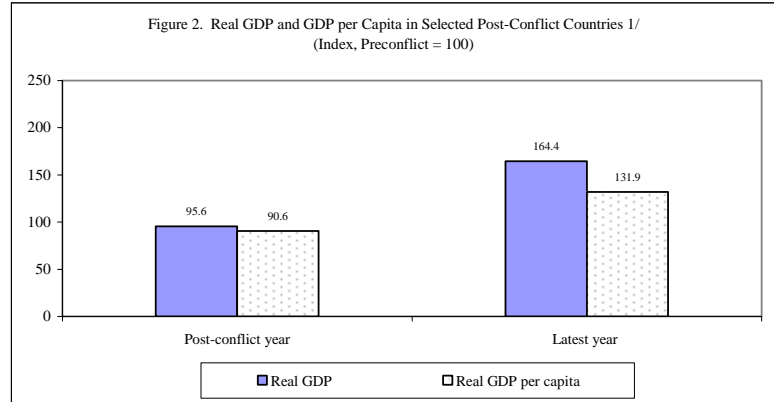
6. Macroeconomic challenges were particularly severe in the fiscal area. The overall

fiscal deficit (including grants) increased only slightly during the conflict (Figure 4).

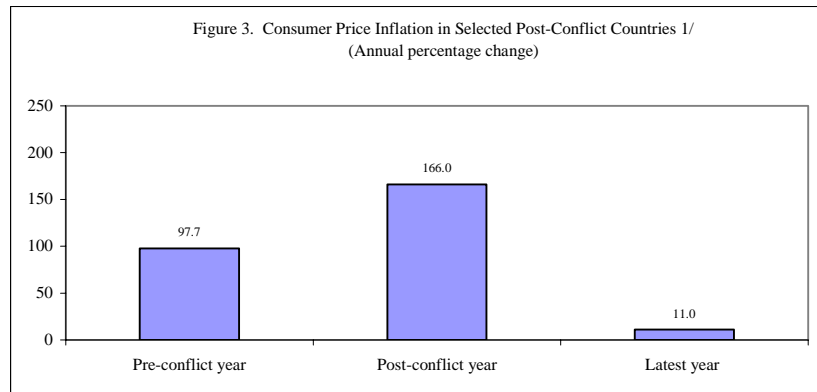
Underlying fiscal developments were, however, much more adverse than suggested by changes in the deficit.⁷ Total revenues, including grants, fell by 2 percentage points of GDP. This primarily reflected a substantial slippage in revenue

effort. In response, government spending was cut back, but not by enough to offset the fall in revenues.⁸ Reduction in outlays on wages and salaries were especially sharp, while military spending increased (Figure 5). Equally worrisome were developments in the financing of the deficit. Net foreign financing fell sharply during the conflict period (Figure 6), forcing countries to rely much more on domestic sources to finance the deficit. Consequently, the domestic financing requirement increased to more than 7 percent of GDP, with adverse consequences for macroeconomic stability, including inflation.

7. Macroeconomic conditions in these countries have improved significantly in recent years. The latest available information indicates that annual real GDP growth averaged about 5 percent, with all countries in the sample registering positive growth rates. Real GDP was about 64 percent



Sources: IMF, *World Economic Outlook* database 2004; and World Bank, *World Development Indicators* database 1/ Based on a sample of 13 countries. See Figure 1 for definition of preconflict year, post-conflict year, and latest year.



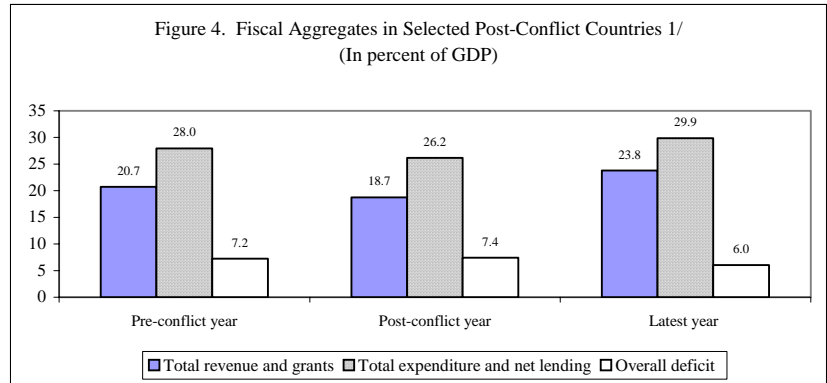
Sources: IMF, *World Economic Outlook* database 2004; and World Bank, *World Development Indicators* database. 1/ Based on a sample of 11 countries. See Figure 1 for definition of pre-conflict year, post-conflict year, and latest year.

⁷ Excluding grants, the overall fiscal deficit worsened by about 2 percent of GDP.

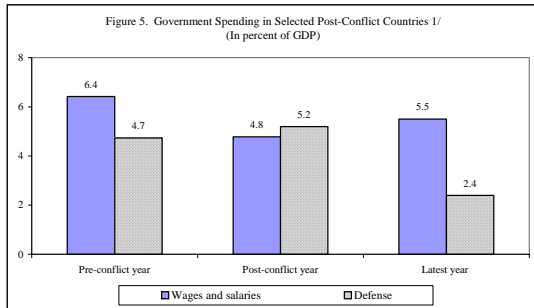
⁸ In a post-conflict setting, there are often a large number of unpaid civil servants and soldiers and the government is unable to provide even a rudimentary level of public services.

higher than its pre-conflict level, with real per capita GDP more than 30 percent higher. There has also been a dramatic reduction in inflation.

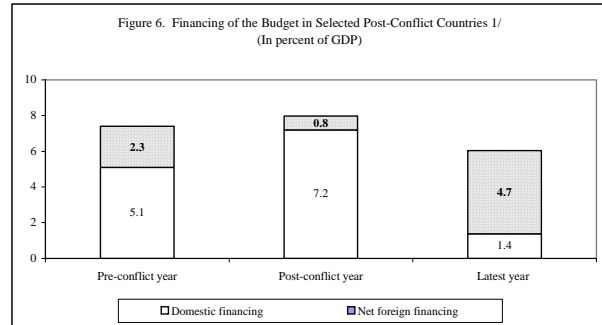
8. The fiscal position has also improved somewhat in recent years. Deficits (including grants) have fallen by almost 1½ percent of GDP.⁹ More importantly, domestic financing of the deficit has been cut sharply, contributing to greater macroeconomic stability. Revenues rebounded and rose as a share of GDP, surpassing their pre-conflict levels. Total government spending rose sharply but military spending declined, to about half its pre-conflict level. As such, it appears that the peace dividend was used by countries both to address fiscal imbalances, as well as to attend to pressing social needs by further increasing government spending.¹⁰



Sources: National authorities; and IMF staff estimates.
1/ Based on a sample of 10 countries. See Figure 1 for definition of pre-conflict year, post-conflict year, and latest year.



Sources: National authorities; and IMF staff estimates.
1/ Based on a sample of 7 countries. See Figure 1 for definition of pre-conflict year, post-conflict year, and latest year. For defense spending, the latest year for Albania, Lebanon, and Mozambique refers to 2002.



Sources: National authorities; and IMF staff estimates.
1/ Based on a sample of 9 countries. See Figure 1 for definition of pre-conflict year, post-conflict year, and latest year.

III. REVIEW OF THE LITERATURE ON INSTITUTION BUILDING IN POST-CONFLICT COUNTRIES

9. The literature on post-conflict aid highlights the important role of rebuilding institutions to facilitate the resumption of economic development and the effective

⁹ The overall fiscal deficit excluding grants also fell slightly.

¹⁰ For an examination of the impact of conflict on social indicators, see Gupta and others (2004).

absorption and management of aid inflows. The pattern observed in many post-conflict countries is 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 aid is rather low in the early post-conflict period. This is partly due to weak political and administrative capacity.¹¹ In this regard, a framework for stabilization, recovery, and development should center on three pillars: (a) rebuilding the state and its key institutions; (b) jump-starting the economy; and (c) addressing urgent needs and reconstructing communities (Addison (2002) and Michailof, Kostner, and Devictor (2002)). An important component of this framework is restoring state capacity for macroeconomic management and fiscal operations. Post-conflict 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 post-conflict phase should be on rebuilding revenue administration and systems.

10. **Sound policies are also important for success in the post-conflict period.** For example, sound macroeconomic policies help sustain a recovery of growth and avoid a relapse into conflict.¹²

11. **At the same time, there is a “virtuous circle” between institution building and the implementation of good economic policies (Addison (2002)).** 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.

12. **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, 2002).¹³

13. **Establishing appropriate institutions and good economic policies is also necessary for attracting private investment in post-conflict countries.** Post-conflict countries need strong and sustained increases in private investment to support broad-based

¹¹ However, a recent paper by Suhrke, Villanger, and Woodward (2004) challenges these findings.

¹² 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. Collier and Hoeffler (2002b) also lend support to this finding.

¹³ Collier and Hoeffler (2002b) identify three structural characteristics which 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 25–30 percent of GDP.

economic recovery (Addison, 2002). Catalyzing this private investment requires the concomitant strengthening of institutions and the policy environment.

14. **In sum, post-conflict peace and economic recovery require 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 is on institution building in the fiscal area.

IV. FAD TECHNICAL ASSISTANCE TO POST-CONFLICT COUNTRIES

A. The Nature and Form of FAD Technical Assistance

15. **FAD has provided considerable technical assistance to post-conflict countries in recent years.** The share of FAD TA devoted to 28 post-conflict countries and entities has increased from 15 percent in 1995 to about 23 percent in 2004 (Table 1).^{14 15} During the last three years, FAD TA to these countries has averaged about 21 person years. Major TA recipients in FY2004 included Afghanistan, Cambodia, DRC, Lebanon, Mozambique, and Rwanda. Considerable assistance was also provided to Iraq in FY2004. More than half of all FAD TA to these countries was in the area of revenue policy and administration, reflecting the urgent need to mobilize revenues for financing rehabilitation and reconstruction. The bulk of the remaining TA was in the area of public expenditure management.

16. **FAD TA to post-conflict countries has ranged from providing policy advice to assisting countries in building technical and institutional capacity** through short-term missions, training, and resident advisors. FAD provides TA only at the request of the

¹⁴ The countries or territories are: Afghanistan, Albania, Algeria, Angola, Bosnia and Herzegovina, Burundi, Cambodia, Democratic Republic of the Congo, Republic of Congo, Croatia, El Salvador, Ethiopia, Guinea-Bissau, Iraq, Kosovo, Lebanon, Liberia, Mozambique, Nicaragua, Rwanda, Serbia and Montenegro, Sierra Leone, Somalia, Sri Lanka, Tajikistan, Timor-Leste, West Bank and Gaza, and Yemen.

¹⁵ Post-conflict countries were selected on the basis of the SIPRI's definition of major conflict and supplemented with information on the "mag" index from the Armed Conflict and Intervention (ACI) project of the Center for Systemic Peace, University of Maryland. The countries selected met two criteria: (i) the conflicts started after 1970 and were resolved or ongoing in the 1990–2003 period; and (ii) they scored at least 3 on the "mag" index of social disruption. Conflicts which met both criteria but in which state institutions remained relatively unaffected were excluded. In addition, three countries (Albania, Guinea-Bissau, and Yemen) where the "mag" index was lower than three but which were declared eligible for IMF post-conflict assistance were included. Documentation on the "mag index" can be found at <http://members.aol.com/cspmgm/warlist.htm>. Detailed information on the ACI project can also be found at <http://www.cidcm.umd.edu/inscr>.

authorities, which helps promote ownership. Progress in implementation of TA recommendations is given significant weight in sustaining the assistance over time.

Table 1: FAD TA to Post-Conflict Countries By Area (FY 1995 - FY 2004)
(in person years) 1/

Area	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Public Expenditure Management	6.1	6.4	7.3	8.7	7.2	8.6	9.7	7.6	7.5	8.9
Revenue Policy and Administration	8.4	10.6	10.5	12.9	9.6	9.9	15.5	11.1	14.9	12.8
Other	0.0	1.0	1.1	0.0	0.0	1.2	0.8	0.6	0.5	0.3
Total	<u>14.4</u>	<u>18.0</u>	<u>19.0</u>	<u>21.6</u>	<u>16.8</u>	<u>19.7</u>	<u>26.1</u>	<u>19.3</u>	<u>22.9</u>	<u>22.0</u>
(in percent of total FAD TA)	15.3	18.3	18.2	20.9	15.4	18.5	23.3	19.8	24.3	23.1
Memorandum items:										
Number of countries or entities	15	19	16	16	16	18	21	23	21	24

Source: FAD Database

1/ Data covers FAD TA to 26 post-conflict countries and 2 entities (Kosovo and West Bank and Gaza)

17. **In general, FAD TA to post-conflict countries has focused on the design of the overall strategy for rebuilding or establishing fiscal institutions.** A first step in the process has been to field an assessment mission to evaluate existing fiscal institutions and procedures and identify areas requiring technical assistance. Donors have typically participated in such missions, which has facilitated agreement among the key TA providers on a common strategy of fiscal management. This has been followed up with smaller, more specialized missions on specific areas including by FAD, other multilateral institutions, and donors. In the initial stages, assistance was often provided through long-term advisors. Furthermore, establishing or rebuilding fiscal institutions also depends on successful implementation of reforms in other areas, especially with regard to the strengthening of the Central Bank and the Central Statistics Office, and to the successful development—particularly in newly formed countries—of an efficient banking system capable of providing cashier and payment facilities throughout the country to assist in the effective delivery of government services.

B. Donor Coordination in the Provision of FAD TA

18. **As noted above, FAD TA to post-conflict countries has been provided in the context of the overall support provided to these countries by the international community.** FAD TA is usually smaller and more focused than large-scale interventions by other bilateral and multilateral donor agencies. In some cases, the effectiveness of FAD TA has depended crucially on complementary support from other providers, such as the provision of long-term advisors and computer equipment. This highlights the need for close coordination among TA providers in these countries.

19. **Coordination of donor technical assistance is often a major challenge in post-conflict countries.** This is a challenge in all countries but is especially so in post-conflict countries, owing to the large number of TA providers involved. Proper coordination among providers is needed to avoid duplication of efforts and to ensure appropriate sequencing of technical assistance. Such coordination also helps avoid placing unnecessary burdens on the weak administrative capacities of post-conflict countries and ensures that technical and financial assistance is channeled in accordance with the priorities established by the country authorities.

20. **In some post-conflict countries, FAD has taken the lead role in coordinating technical assistance.**¹⁶ Whenever the authorities requested it, comprehensive medium-term action plans for provision of technical assistance were drawn up, based on a series of diagnostic and assessment missions. These plans identified the objectives, types and amount of assistance required, costs and potential funding sources, government commitment and counterparts, management and administrative arrangements, and implementation benchmarks and performance indicators, as well as reporting and evaluation requirements. Such plans provided a framework for prioritizing technical assistance needs and building country ownership and commitment, as well as mobilizing and coordinating donor support for technical assistance.

V. REESTABLISHING FISCAL MANAGEMENT AND INSTITUTIONS IN POST-CONFLICT COUNTRIES

21. **While this section attempts to paint a broad picture of the nature of FAD TA advice, there were differences in recommendations across countries.** This caveat is important, especially when specific measures are discussed.

22. **The preferred strategy for the rebuilding of fiscal institutions in the wake of conflict included three basic steps:**

- The creation of a proper legal and/or regulatory framework for fiscal policy;
- The establishment of a central fiscal authority and a mechanism for coordinating foreign assistance; and finally
- The implementation of priority changes in revenue and expenditure policies, along with the creation of simple administrative arrangements in revenue administration and public expenditure management (PEM) that effectively leverage scarce human resources.

23. **The sequencing of the steps did not always follow the pattern described above.** For example, while establishing a fiscal authority is a necessary early step in countries where

¹⁶ For example, Cambodia, Mozambique, and Yemen.

no such institution existed before, setting up of the authority could take some time. However, certain tax administration procedures may need to be promulgated even if the authority is not fully functional. These include, 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 need to be put in place urgently and may not await the setting up of a fiscal authority. In some cases, this had to be done before a comprehensive budget was prepared. Sometimes FAD provided recommendations for executing spending on salaries and purchases of other goods and services until a fiscal authority became operational (e.g., Timor-Leste).

24. The relative importance and sequence of each of these steps also depended on the type of conflict:

- (i) **conflicts that led to the emergence of new countries or took place immediately after the creation of a new country** (e.g., Bosnia and Herzegovina, Croatia, and Timor-Leste). In most cases, these countries followed closely the three-step framework described above.
- (ii) **conflicts in pre-existing countries with widespread institutional damage and social disruption** (e.g., Afghanistan, Cambodia, DRC, Lebanon, Liberia, Mozambique, and Rwanda). These countries also followed the three-step framework but the sequencing was not always the same. In some cases (such as Rwanda and DRC), the first priority was to rebuild the basic infrastructure of the ministry of finance, and only later was emphasis placed on creating a proper legal framework for fiscal policy. In countries where the legal framework for budget preparation and execution was basically sound (though it had not been applied for many years—e.g., Afghanistan), other important legal reforms were recommended (such as reforms of the Income Tax Law, Foreign and Domestic Private Investment Law, and Customs Service Law). Liberia and Cambodia more closely followed the three-step framework.
- (iii) **conflicts in pre-existing countries with a low to moderate degree of institutional and social disruption** (e.g., Albania, Serbia and Montenegro, Sierra Leone, Tajikistan, and Yemen). These countries did not follow all the steps. In the case of Albania and Serbia and Montenegro, the conflict was intense but short. As a result, fiscal institutions emerged from the conflict relatively unscathed. The focus was instead on the third step. For example, in Albania the immediate priorities included (i) restaffing all tax administration offices; (ii) increasing the reporting threshold for value-added tax (VAT); and (iii) securing the cooperation of banks in accepting tax payments. Similarly, in Serbia and Montenegro, the focus was on simplifying the tax system to facilitate the transition to a more modern and market-friendly tax environment.

25. The approach to rebuilding fiscal institutions 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 the advice given. In these countries or territories, a special challenge was to ensure that local capacity was in place before responsibility was handed over to national administrators. In Kosovo, for example, a number of complicated legal issues arose as a result of the United Nations Interim Administration Mission in Kosovo (UNMIK)'s control over the territory. These included (i) whether UNMIK had the right to ignore existing regulations inherited from the Federal Republic of Yugoslavia (FRY) and had the mandate to pass new regulations in contradiction to these rules; (ii) whether Kosovo was accountable for any of FRY debt; (iii) whether UNMIK could incur liabilities; and (iv) whether UNMIK had the right to fire redundant workers. Similarly, in the case of Bosnia and Herzegovina, the Dayton Agreement largely determined the parameters within which the reconstruction of institutions had to take place. For example, the agreements spelled out a highly decentralized fiscal arrangement to accommodate different ethnic and political interests. This led to the emergence of a new state composed of two "entities"—Republika Srpska and the Federation of Bosnia and Herzegovina—and Brcko District. The agreement further mandated the creation of at least eight local cantons of which only two had functioning administrations.

26. **The post-conflict era sometimes 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, in some cases the immediate post-conflict period provided an opportunity to put in place major improvements in policies and institutions relative to the pre-conflict era (e.g., Kosovo and Timor-Leste).

A. Create a Proper Legal and/or Regulatory Framework for Fiscal Policy

27. **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 legislature, 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. New or revised financial regulations are also indispensable to ensure that the fiscal authority is vested with the legal authority to control and manage public spending.

28. **The creation of a consolidated package of customs and tax legislation, regulations, and directives was often a measure of immediate importance in post-conflict countries.** In countries where pre-conflict legislation was not reasonably sound, a key objective was to simplify tax legislations 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 legislations made tax laws difficult to implement, especially in light of the limited administrative capacity prevailing in a post-conflict 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.

29. **A number of countries viewed the reform of customs and tax laws as crucial.** In Rwanda, the authorities initiated a comprehensive program to reduce tax exemptions and combat tax evasion, including through a review of special conventions in the investment code. In the DRC, a new, simplified tariff law was adopted to reduce the scope for smuggling and fraud. A new mining and investment code was adopted to combat tax evasion. In Serbia and Montenegro, legislation was introduced to radically simplify the real estate property tax.¹⁷ In newly created countries like Bosnia and Herzegovina, substantial resources were devoted to the fashioning of tax laws nearly from scratch to provide a legal framework for the a new, albeit simplified, tax system. In several post-conflict countries, the IMF's Legal Department (LEG) provided substantial assistance in drafting these laws (Afghanistan, Albania, Liberia, Mozambique, Rwanda, Tajikistan, and Timor-Leste).

30. **Preparing a new Budget Law, and adopting a first post-conflict budget—sometimes a transitional one covering three to four months—were also key for initiating budget reforms.** Formulation of the first budget after the conflict was one of the important measures to be implemented. In most cases, the existing Budget Law no longer reflected the current institutional structure (e.g., Afghanistan, Bosnia and Herzegovina, and Croatia). The purpose of the new Budget Law was to set out clear and transparent budget classification structures (consistent with international standards and practices); provide strict guidelines for budget execution such as the prohibition of unbudgeted expenditures and arrears; establish a consistent framework for internal control and internal and external audit; and provide mechanisms for the financing of budget deficits.

31. **The new legislation also had to address issues related to off-budget transactions, lack of clear classification of budgetary spending, and the absence of well-established procedures for managing foreign aid.** Legal reform on PEM issues was also key. In Croatia, for example, FAD quickly fielded a mission one month following the announcement of the government's stabilization program. The mission identified an urgent need for a strong legal framework for public expenditure management suited for a market economy.¹⁸

32. **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**

¹⁷ This tax accounted for less than two percent of the Republic of Serbia's revenue and yet the law prescribed very burdensome procedures for its administration. Revenue agencies had to adjust each year the taxable value of 1.6 million properties, based on information collected from 160 counties on sales of new buildings.

¹⁸ The existing legal framework required further delineation of revenue and expenditure assignments for the new layers of government envisioned under the authorities' fiscal decentralization plans. Legislative amendments were also required to strengthen the authority of the ministry of finance for fiscal management and provide the basis for a modernized treasury.

rule of law. The success or failure of these tax and budget reforms themselves depended heavily on the capacity of the state to reestablish order and develop a system of judicial sanctions to penalize those who evade them (Maravall and Przeworski, 2003). Therefore, ensuring that key legislation was in place authorizing the tax and customs administrations to perform their basic duties was high on the list of priorities. The underlying strategy was to start simple. The strategy usually pursued was to start with very basic and short laws consistent with a streamlined tax policy. 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

33. **Strengthening the central fiscal authority, or establishing one from scratch in new countries, was an essential step in all cases.** 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. In a few cases (e.g., Albania, Bosnia and Herzegovina, Serbia and Montenegro, and Tajikistan), this also involved the transformation of existing institutions designed for a planned economy into those that would support a more market-oriented system. 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 establishing transparency in fiscal operations. A third objective was to ensure a minimum level of revenue collection. A fourth objective was to ensure that government spending was consistent with the government's priorities. Establishing a set of procedures to effectively control government spending and 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.

34. **The fiscal authority was designed 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.

35. **In newly created countries, 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 (including for tax revenues) and budget

execution reports. This department would also have responsibility for assessing the fiscal impact of policy measures.

- b. *A treasury department* responsible for controlling spending and ensuring that it is properly accounted for. The development of the treasury function is closely related to the establishment of a well-functioning payments system, since the treasury department is also charged with 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. As noted earlier, external aid inflows tend to increase in the post-conflict phase. Therefore, setting up a mechanism for the proper accounting of domestic and external borrowing and other inflows is important. Where needed, such a function should be integrated with the treasury department to coordinate and control these flows as well as to ensure proper recording and reporting.
- 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 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, FAD TA argued in favor of establishing separate customs and domestic tax administration departments, with the former entrusted with the responsibility for collecting trade taxes.

36. **In some cases a macrofiscal unit was also recommended to help support policy formulation** (e.g., Afghanistan, Albania, Bosnia and Herzegovina, Cambodia, Liberia, and Tajikistan). The unit was expected to provide advice on general fiscal policy issues and the preparation of the budget (e.g., Albania, Bosnia and Herzegovina, Croatia, Kosovo, and Liberia). More specifically, it would assist the ministry of finance in preparing revenue forecasts for the budget year and fiscal policy scenarios. This unit's task included: (i) preparing a medium-term expenditure framework; (ii) conducting debt sustainability analysis; (iii) analyzing tax policy issues; and (iv) assessing structural fiscal issues such as pension reform. The timeframe for the establishment of this unit varied, depending on country-specific circumstances. For example, the establishment of the macrofiscal unit was recommended as a medium-term measure in Rwanda. However, in the case of Afghanistan it was seen as a measure of immediate importance, as the new unit was intended to address the limited capacity for economic analysis within the ministry of finance.

37. **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 cases, a separate unit was set up to coordinate with donors, often as part of the ministry of finance or its equivalent institution (e.g., Kosovo and Mozambique). In other cases, however, a multi-donor trust fund was set up that carried out the coordination function (e.g., Afghanistan and Timor-Leste). Frequent donor meetings also provided an opportunity for coordination of assistance (e.g., Timor-Leste).

38. **In some cases, the establishment and consolidation of power of the central fiscal authority created challenges for the difficult political equilibria reached during the resolution of the conflict.** In three cases (Bosnia and Herzegovina, Croatia, and DRC), issues of fiscal federalism/decentralization quickly acquired importance, given the strength of sub-national/regional political forces with strong secessionist roots. In these cases, it became important to follow a strategy where the decentralization that was often necessary to keep the peace in ethnically based conflicts did not endanger economic reforms and fiscal management.

39. **FAD recommended a flexible approach to fiscal decentralization in post-conflict countries to address these concerns.** For decentralization to be successful and consistent with sound macrofiscal management, adequate administrative and institutional capacity at the subnational levels was viewed as critical. FAD thus recommended that fiscal decentralization proceed flexibly over the medium-term in tandem with the development of local capacity. In the DRC, it was recommended that the transfer of responsibilities to subnational governments be linked to progress in building local capacity. In this light, it was advised that the share of revenues transferred to local governments in the DRC be determined in the annual budget, rather than be explicitly stated in the decentralization law. In Bosnia and Herzegovina, local capacity was either disrupted or non-existent, although the post-conflict political consensus had devolved significant responsibilities to subnational governments. While the existing distribution of responsibilities among different levels of government was generally seen as appropriate, it was nevertheless recommended that these arrangements be reviewed to take account of changing circumstances.

40. **FAD's advice on decentralization focused on the overall framework governing inter-governmental fiscal relations.**¹⁹ These related to the clarification of revenue and expenditure assignments among the different levels of government (Bosnia and Herzegovina, Croatia and DRC). The devolution of authority to subnational governments sometimes called for the creation of new institutions to coordinate policies and to reduce undesired tax competition (e.g., Bosnia and Herzegovina). In some cases, an important issue was the role of intergovernmental fiscal relations in addressing regional income disparities (Bosnia and Herzegovina and Croatia). In such cases, FAD recommended a transparent revenue-sharing mechanism and a system of equalization grants. Restrictions and clear rules on subnational government borrowing were also recommended.

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

41. **A number of actions were recommended to reform tax policies, strengthen tax administration, improve expenditure policies, and strengthen expenditure management and control.**²⁰ In some cases, some of these actions were to be taken at the time that enabling laws were passed (see discussion above).

Policies to Mobilize Revenues

42. **Mobilizing domestic revenues presented a difficult challenge in the post-conflict 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 (e.g., Cambodia, DRC, Liberia, Rwanda, and Timor-Leste).

43. **The immediate objective of tax policy in post-conflict 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 large macroeconomic imbalances (Cambodia and Serbia and Montenegro).** 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. However, the strategy for revenue generation had to take into account the state of existing institutions and capacity available to

¹⁹ FAD did not typically provide assistance for institution building at the subnational levels. This task was undertaken by other multilateral institutions and donors. For example, in DRC, the World Bank provided advice on strengthening fiscal management capacity at the provincial level. The World Bank also has capacity building projects aimed at local levels of government in Bosnia and Herzegovina. USAID has provided assistance to Bosnia and Herzegovina for strengthening local public sector accounting.

²⁰ Advice on expenditure policy and priorities in post-conflict countries was provided by other development partners, and thus is not reviewed here. In a number of cases (e.g., Cambodia, DRC, Timor-Leste, Lebanon, Rwanda, Sierra Leone, Tajikistan, and Yemen), the World Bank provided advice on expenditure composition in the context of a Public Expenditure Review (PER).

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 needs and economic efficiency objectives. Given the limited options available for generating revenues, governments in some instances were advised to implement taxes that were less than desirable from an efficiency point of view, or to move only gradually in restructuring distortionary taxes already in place (e.g., Croatia, Liberia, Serbia and Montenegro, and Tajikistan).

44. **A major challenge for some countries was posed by the fact that a large share of the tax base—in particular, incomes of those working for international institutions—was exempt from income taxation.** Many post-conflict countries experienced a large influx of expatriates in connection with relief and reconstruction work. In general, these incomes were exempt from income taxation. The differential treatment of expatriates risked creating a culture of tax exemptions, and made it more difficult to implement a simple tax system where all taxpayers faced a level playing field (e.g., Liberia).

45. **In already 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 (e.g., West Bank and Gaza). 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, assistance focused in the early post-conflict period on restoring capacity in revenue administration (e.g., Albania and Sierra Leone). Tax instruments were left largely intact, except for modifications to make them simpler, more transparent, and easier to implement. Some emphasis was also placed on the collection of arrears, as in Yemen, where a key FAD recommendation was to accelerate collection of tax arrears from public enterprises, as well as arrears on profit transfers to the budget. 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 (e.g., Rwanda, Tajikistan, and West Bank and Gaza). 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 (e.g., Bosnia and Herzegovina).

46. **In most post-conflict countries, revenue mobilization relied heavily on indirect taxes.** In the initial stages, the emphasis was on international trade taxes (including sales tax and excise imposed on imports). 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.²¹ A sales and excise tax on

²¹ This represented a radical departure from existing practices for some countries; in Afghanistan, for example, where trade taxes accounted for up to 70 percent of total tax revenue, tariff rates had ranged from 7 to 150 percent and were allocated across 888 tariff headings.

imports was also introduced in some cases, again with a simplified structure. In the initial post-conflict 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.

47. **Exchange rate policy also had an impact on revenue collection in post-conflict countries that were highly dependent on international trade.** For example, in the DRC, immediate unification of the official and parallel market exchange rates had a large positive impact on budgetary revenues, since about 60 percent of total government revenue was derived from a dollar-denominated tax base. In Lebanon and Rwanda, adjustment of the customs exchange rate towards the market rate was a key recommendation, while in Yemen, the authorities adopted a unified exchange rate and aligned the customs exchange rate with the unified rate, with an immediate positive impact on revenues.

48. **Some countries also introduced or maintained 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, an export tax was seen as another area for revenue mobilization in the early post-conflict 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 post-conflict countries, however, this was not a viable option for raising a 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 (e.g., Liberia and Tajikistan).

49. **Taxes on selected (relatively easily taxable) services such as restaurants, hotels, and car rentals were recommended** (e.g., Cambodia, Kosovo, and Timor-Leste). 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.

50. **In a few countries, changes in administered prices also provided an important source of revenue.** For example, domestic market prices of petroleum products were adjusted significantly in order to generate revenue, rationalize the consumption of energy, and discourage smuggling to neighboring countries (e.g., Yemen). This was followed by the

introduction of a comprehensive system for taxing energy (or other natural resources) from domestic sources.²²

51. **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 pre-conflict period. Thus, although the tax was complex to administer, there was previous experience to draw upon 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 of the country, 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 (e.g., Cambodia, Lebanon, and Tajikistan).

52. **A particularly attractive form of income taxation in the early post-conflict period was a flat withholding tax on wages** (e.g., Albania, Afghanistan, Bosnia and Herzegovina, Kosovo, and Timor-Leste). This had three advantages. First, the administration of the tax was relatively straightforward. Second, given the relatively small private sector, most of the taxpayers would be public servants or local employees of international organizations working on relief and reconstruction projects. In addition, in some cases (e.g., Afghanistan), this applied, initially, to relatively high income earners. Thus, the tax would not affect the large majority of the population, thereby reducing resistance to this measure. And, third, in some cases (e.g., Albania, Bosnia and Herzegovina, and Kosovo), there was some sort of a tax on wages before the conflict began, and thus the reintroduction of the tax in the early stages of the post-conflict period was deemed appropriate.

53. **Measures were also suggested for taxing business income** (e.g., Bosnia and Herzegovina, Kosovo, Rwanda, and Timor-Leste). In the initial stages, a presumptive tax on income was recommended for small businesses (e.g., Kosovo and Timor-Leste). 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 projected to be significant, it was envisaged 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. In one case (Yemen), a minimum business profits tax of between one to two percent of the previous year's turnover was proposed—a measure that could be implemented without the passing of a new law.

²² Nontax revenues, such as timber royalties and other fees, can also serve as new sources of revenue in the post-conflict era (e.g., Cambodia).

54. **It was recommended that corporate income taxes be simplified** (e.g., Cambodia and Rwanda). In some cases, a profit tax existed, but yielded paltry revenues on account of excessively generous tax incentives (e.g., Afghanistan). 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 other cases (e.g., Liberia and Rwanda), the recommendation was to replace the progressive corporate tax with a flat income tax on all business income. It was also suggested that investment incentives be streamlined and made more transparent (e.g., Rwanda).

Strengthening Revenue Administration

55. **In newly created countries, a revenue administration (tax and customs) needed to be established.** In existing countries, depending on the degree of disruption caused by the conflict, some revenue administration capacity was preserved, but it was less effective than before the conflict.

56. **Establishing and strengthening revenue administration in post-conflict countries generally involved a two-stage process.** In the first stage, the priority was to get the tax/customs administrations “up and running.” This meant starting revenue collection and registering/controlling the flow of goods across borders—within the twelve months immediately following the end of the conflict. In the second stage—anywhere from twelve to eighteen months after the conflict—the emphasis was placed on helping countries design, and begin implementing, a medium- to long-term strategy for reforming revenue administration. Such strategies were designed to fit country-specific circumstances and based, as much as possible, on international best practices.

(a) *Reestablishing basic tax administration infrastructure*

Once key legislation was put in place (see above), a critical priority was to secure the basic infrastructure (buildings, office equipment, and materials) for a functioning revenue administration. In newly created countries or territories (e.g., Bosnia and Herzegovina, Kosovo, and Timor-Leste), often the very basic requirements for a functioning national revenue administration, such as telephone lines, vehicles, and physically sound buildings were needed before operations could even begin. In many countries (e.g., Albania, Serbia and Montenegro, and Timor-Leste), international financing was made available for this purpose. In all cases, the IMF worked closely with the authorities and donors to mobilize the resources and define their use. The need for a basic information system that permitted the authorities to produce revenue statistics and monitor key operations (such as the number of registered taxpayers, tax returns filed, and payments made) was identified. In Rwanda, for example, provision of basic equipment and the reinforcement of mobile surveillance and anti-smuggling operations were deemed to be an early priority. Given countries’ limited capacity, it was often recommended that the process of modernization begin with a few selected tax offices collecting the bulk of government revenue.

(b) Identifying and appointing key staff

An important step in getting the revenue administrations up and running was to identify and appoint key staff in senior positions. This was a challenging task in countries without a pre-existing national revenue administration or a seriously impaired one following the conflict (e.g., Albania and Timor-Leste), as there was no pool of experienced government officials to manage and staff the revenue administration. In some cases (e.g., Timor-Leste), at the request of the countries, FAD's technical assistance included identifying a foreign expert who could serve as a "shadow" commissioner. This senior official would take the lead in managing the fledgling revenue administration while working closely with national counterparts to train local staff. The objective was to transfer management responsibilities to local personnel in as short a time as possible.

(c) Registration and taxpayer identification

In newly formed countries (e.g., Timor-Leste), legislation was needed to require individuals or companies engaged in commercial activities to register with the authorities. In cases where a taxpayer register existed (e.g., Kosovo), 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 register. 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) (e.g., Bosnia and Herzegovina, Kosovo, Liberia, Serbia and Montenegro, Rwanda, and Timor-Leste). This number would be used by taxpayers for filing their taxes. The TIN was expected to (i) effectively identify taxpayers on a nation-wide basis, (ii) assist the revenue administration in crosschecking information on taxpayer compliance, and (iii) at a later stage, facilitate computerization of tax administration.

(d) Establishing basic filing and payment procedures

Simple procedures for filing and payment of taxes or simplification of existing procedures were recommended. In many cases, simple return filing and payment procedures were set up that would be easy for taxpayers to comply with and place the least administrative burden on the fledgling revenue administrations (e.g., Kosovo and Timor-Leste). Tax return forms were simplified to enable taxpayers to calculate and report their tax liabilities accurately and easily. In some countries, the national language changed as a result of the conflict, and new forms were designed to take this into account. Countries were also advised to undertake public information campaigns to educate taxpayers on procedures for calculating their tax liabilities, completing their tax returns, and paying the taxes owed. Internal procedures for processing tax returns and payments, and reconciling payment information with that of the banks and the national treasury, were also defined. A well-

functioning payments system is necessary to facilitate tax payments and collection. This also highlights the importance of progress in financial sector reform for the rebuilding of fiscal institutions.

(e) *Creation of a Large Taxpayers Unit (LTU)*

An LTU, focusing on taxpayers accounting for a significant majority (usually 60 to 80 percent) of the tax revenues, was recommended in many cases (e.g., Albania, Kosovo, Liberia, Serbia and Montenegro, Timor-Leste, and West Bank and Gaza). In the initial phases of the post-conflict period, enforcing compliance with basic tax regulations was a major challenge. Scarce administrative capacity could best be used, it was argued, by concentrating on the relatively small number of taxpayers accounting for the lion's share of tax collections. In the latter phases of the post-conflict period, focusing audit activity on firms monitored by the LTU was seen as more effective in helping raise these taxpayers' compliance (and thus revenue) than more generalized approaches applied 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 with respect to new organizational structure, systems, and procedures (taxpayer registration, filing and payment, audit, enforcement, and taxpayer services), based on best practices. Setting up the LTUs in a post-conflict environment, however, was not an easy task. First, they required a qualified pool of tax staff who could effectively audit the large taxpayers. This necessitated a higher degree of preparation and training than was often available in post-conflict countries. Second, 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.

Reestablishing Expenditure Management and Control

57. **Upon entering the post-conflict era, most countries lacked a well functioning PEM system.** The immediate objectives for improving budget management in post-conflict environments included (i) restoring control over the expenditure aggregates (fiscal discipline), (ii) ensuring that budgetary spending was consistent with the approved budget, and (iii) giving donors fiduciary assurances that their money would be spent in line with their objectives. The last point was particularly important, given that most post-conflict countries received a substantial amount of foreign assistance for humanitarian and reconstruction purposes. Thus, the objective of obtaining 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. These concerns underscored the need for urgent attention towards improving PEM systems in post-conflict countries.

58. **Ensuring that the budget was executed—and not just that total expenditures were under control—was also a central challenge in the post-conflict era.** In some countries, budgets were not being executed, given the inexperience of the government. In part, this was due to poor budget planning, with unrealistic estimates of the capacity to

implement capital projects incorporated in the budget. This implied that some critical programs for reconstruction were not being implemented.

59. **Some aspects of the PEM system were accorded greater priority than others in the early post-conflict period.** Two areas received special attention during this phase: (i) ensuring that the central authority had control over all revenues and expenditures (e.g., Croatia, DRC, Liberia, Serbia and Montenegro, and West Bank and Gaza) and (ii) establishing a simple accounting and reporting framework with an appropriate budget classification (e.g., Albania, Rwanda, Serbia and Montenegro, Timor-Leste, and West Bank and Gaza). In countries where a system was already in place, the approach was to strengthen existing systems. In other countries, the emphasis was on establishing basic PEM systems that were capable of timely and transparent formulation and reporting of expenditure and revenues at a fairly aggregate level.²³ In some cases (as noted above for Bosnia and Herzegovina and Croatia), however, the nature of the conflict did not permit the centralization of all revenues and expenditures.

60. **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 or territories—Timor-Leste, Kosovo, and Rwanda—a crash-course of training in basic accounting, financial management, and computer operations was seen as critical for getting the PEM system up and running.

61. **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 fiscal operations conducted through extrabudgetary channels by integrating all government revenues and expenditures into the treasury (e.g., Albania and DRC).²⁴ Another complicating factor was that in the initial post-conflict phase, a large part of both recurrent and capital expenditure was financed by donors. In some cases, donors wished to maintain control over the outlays financed by them. This led to an additional PEM problem—bifurcation of the budget system into a “local resources” budget and an externally funded capital budget, with the latter being outside the control of the authorities. 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.

²³ In Timor-Leste, for example, it was recommended that a rudimentary budgetary circular be prepared that would provide key assumptions, for example on staffing, for the spending departments to submit their budget requests.

²⁴ Lags in fiscal reporting were also a concern, including in the post-conflict period. For example, in Afghanistan, for a period of over six months, the treasury did not receive any cash transfers from about half of the provincial tax-collecting agencies.

62. 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 the quality of financing data and to simplify the process of collecting this information, a Treasury Single Account (TSA) was recommended in some cases (e.g., Albania, Croatia, DRC, Kosovo, Liberia, and Serbia and Montenegro). It was envisaged that all government revenues and expenditures would flow through the TSA. It was expected that, over time, the TSA would also allow for better cash management by consolidating cash resources in a single account.

63. 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 (e.g., DRC). In some cases (e.g., Afghanistan), spending agencies held accounts in commercial banks and the approach was to gradually consolidate these accounts in the TSA.²⁵

64. The recommended route for achieving the second objective—a meaningful accounting framework—varied according to country circumstances.

In some countries (e.g., Afghanistan), 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 post-conflict period. However, in others this was not the case (e.g., Albania, Cambodia, Croatia, and DRC), and in newly created countries (e.g., Timor-Leste), 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 system 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, to both the government and donors (e.g., Serbia and Montenegro).

65. 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 (e.g., Bosnia and Herzegovina, Cambodia, Croatia, Serbia and Montenegro, and West Bank and Gaza). A system to control spending at the commitment stage was also advocated. In some cases (e.g., Serbia and Montenegro), early implementation of commitment control was recommended to contain growing arrears. In other cases (e.g., Albania and Croatia), this was a medium-term priority. In cases where a commitment control system already existed (e.g., Rwanda and DRC), a

²⁵ In Afghanistan, for example, there were literally hundreds of different bank accounts.

strengthening of the system was recommended. A basic computerized system to process checks, record information, and produce timely fiscal reports was also suggested in some countries (e.g., Afghanistan); in others (e.g., Timor-Leste), however, computerization was only viewed as feasible for central offices, with branch offices continuing to use manual procedures.²⁶

66. **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 (e.g., Rwanda). Over time, it was 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.

67. **A strengthening of audit capacity was also recommended.** 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 (e.g., Croatia, Serbia and Montenegro, and Rwanda). In Rwanda, FAD recommended a review of the adequacy of financial controls and greater clarity of responsibilities of the auditor general's office. In Serbia and Montenegro it was proposed that the jurisdiction of the national audit office be extended to all public spending agencies.

VI. LESSONS

68. **A number of lessons can be drawn from FAD's involvement in post-conflict situations.** These lessons are highlighted, in particular, by the more detailed case studies presented in the accompanying background paper. Many of these lessons also apply to countries where capacity to implement macroeconomic policies is impaired due to weak institutions (see Box 1).

Lessons on design of the strategy

- **A realistic overall strategy should be designed upfront and in consultation with donors.** This should include measures to get the government immediately up and running (e.g., to pay wages and provide basic services), as was recommended in Timor-Leste. The strategy should not underestimate capacity constraints, and should avoid setting up an unrealistic timetable for implementing certain reforms. In practice, some reforms have taken longer to implement than expected. Experience in Bosnia and Herzegovina, for example, suggests that a basic expenditure control system can be set up relatively quickly, while strengthening analysis and policy

²⁶ In most countries, full computerization of the treasury ledger and payments system was viewed as a medium-term (rather than short-term) objective.

development capacity takes much longer. The strategy should lay down a road map of actions with appropriate sequencing and prioritization, and identify TA needs and TA providers. This can also facilitate coordination of donor activities.

- **In cases where there is little or no administrative capacity, long-term advisors can play a critical role in building capacity and transforming skills in the early post-conflict stages.** As capacity improves, these experts should play a more advisory role. In some cases, such as Timor-Leste, FAD assisted in identifying expatriate personnel who could take up senior positions in key fiscal institutions and work closely with national counterparts to train local staff. The objective in these cases was to transfer management responsibilities to local personnel in the shortest possible time. In other countries, such as Cambodia and DRC, these advisors assisted country authorities in implementing TA recommendations and also helped train local staff. The tenure of long-term advisors will vary from country to country and depend on the pace of implementation of reforms and development of local capacity.
- **Initial steps should focus on designing and implementing simple revenue policies and administration, and public expenditure management procedures.** As local

Box 1. Applicability of the Approach to Other Countries

The three-step approach presented in this paper has applicability beyond the post- conflict countries. In particular, this approach would be relevant for low-income countries with weak institutional capacity, countries where institutions have been damaged due to natural disasters, and countries emerging from long periods of international isolation. The approach would, however, have to be appropriately adjusted to reflect realities on the ground, which could differ from those in a post-conflict environment. In countries with very low institutional capacity, the three-step approach would remain largely valid. In others, the legal framework may be sound, but policies and procedures may need to be improved to remove distortions or to match the capacity available. In such cases, the second and third steps would be more relevant. In all of these cases, the country would need a flexible TA (technical assistance) strategy, good coordination with other TA providers, and strong country ownership.

In general, FAD's policy advice for rebuilding fiscal institutions in low-income countries is similar to what has been proposed in the post-conflict context.

Withholding tax on wages, taxes on selected services, improving revenue administration through establishing a large taxpayers' unit, introducing taxpayer identification numbers, consolidating government accounts, and improving the classification system for government expenditures are part and parcel of FAD recommendations for low-income countries.

In many low-income countries there will be less of a need to rely on policies that are second-best. Often the choice of second-best policies in post-conflict countries reflects the need to generate revenues quickly, as well as limited capacity in the aftermath of a conflict. The macroeconomic circumstances of many low-income countries—especially those that have achieved a modicum of macroeconomic stability—are such that many of these second-best policies could be suboptimal, given the distortions they entail. If emergency situations require implementation of such policies (e.g., an export tax or an import surcharge), these should only be temporary and phased out as soon as possible. In low-income countries, there is usually a strong emphasis on strengthening tax administration and the capacity to implement tax policies that avoid the distortions associated with these second-best options. In the PEM area, systems in low-income countries have many weaknesses, but are often in better shape than in countries immediately emerging from conflict. In the latter, there may be no disaggregated data on expenditures. In low-income countries, TA in the PEM area has focused on needed improvements in budget formulation, execution, and reporting, including through the introduction of program and/or functional classification of expenditures.^{1/}

1/ For a recent review of the PEM systems in HIPC countries, see <http://www.imf.org/external/np/hipc/2002/track/032202.pdf>.

capacity develops, these can be upgraded. With respect to revenues, for example, it was found useful to focus on basic procedures for filing returns and paying taxes that would be easy for taxpayers to comply with, and for the administrative system to implement (e.g., Kosovo and Timor-Leste). In a similar vein, in light of scarce capacity, LTUs were recommended in Albania, Liberia, Serbia and Montenegro, Timor-Leste and West Bank and Gaza. In the PEM area, a similar strategy was recommended through the introduction of a simplified expenditure classification system in Albania, Croatia, DRC, and Timor-Leste.

- **In framing policies and procedures, it may sometimes be necessary to deviate from first principles.** Post-conflict countries often faced a trade-off between short-term revenue mobilization and economic efficiency objectives. In this light, many countries had to move gradually to address inefficiencies in some taxes (Croatia, Liberia, Serbia and Montenegro, and Tajikistan). Thus, policies that are sub-optimal from an efficiency point of view may need to be implemented for some time. However, these should be presented as temporary, and be phased out as quickly as possible.
- **Where possible, short-term measures should be consistent with the longer-term objective of moving to a modern fiscal system.** For example, the taxes recommended for the early stages of post-conflict institution-building helped lay the groundwork for a more efficient tax system that could only be implemented at a later stage. Some countries or territories introduced withholding tax on wages (e.g., Afghanistan, Albania, Bosnia and Herzegovina, Kosovo and Timor-Leste) and a presumptive tax on small business (e.g., Kosovo and Timor-Leste). As capacity developed, these were expected to be transformed into a more refined system of personal and corporate taxation. A similar strategy was recommended for indirect taxation, as in the initial stages, a tax on selected services was proposed in Cambodia, Kosovo and Timor-Leste. The development of this tax base could help set the stage for the development of a full-fledged VAT over the longer term. In some cases, (e.g., Afghanistan and Timor-Leste) tax policy options were constrained by the limited mandate of transitional administrations.
- **Fiscal decentralization poses a challenge to fiscal management in post-conflict countries.** It is essential to ensure that the decentralization often needed to keep the peace in ethnically based conflicts does not endanger economic reforms and fiscal management. A flexible approach to decentralization was recommended to address these concerns. It was stressed that revenue and expenditure assignments should be clearly identified, with an appropriate transfer mechanism to mitigate regional income disparities. Emphasis was placed on the need to develop capacity for effective fiscal management at the subnational level. Given FAD's limited resources, other development partners had to be relied upon in providing such assistance to subnational governments.

Lessons on implementation

- **The reform strategy should be flexible enough to respond to changing circumstances on the ground.** The strategy may need to be adjusted in the context of emerging priorities or as new issues/weaknesses come to light. The pace of implementation of reforms may also necessitate a change in the strategy. For instance, the slow pace of implementation and the need to track poverty-reducing spending necessitated a revision of the overall TA strategy in the DRC. In Afghanistan, the weakness of public expenditure management was initially underestimated, as the security situation did not permit mission travel outside Kabul. As a result, the strategy was adjusted following a detailed assessment by subsequent missions. In Mozambique, the initial implementation plan for PEM reforms was found to be unrealistically ambitious, requiring later revisions.
- **Strong commitment by country authorities is an important determinant of the pace of reforms.** Progress was rapid where ownership and commitment of the country authorities were strong. For instance, progress was slow in the DRC in the early post-conflict stages until the transitional government reiterated its commitment to structural reforms. Progress on tax reform was also initially slow in Bosnia and Herzegovina, reflecting weak ownership at different levels of government, but accelerated when the distribution of powers regarding tax policy and administration was clarified. To secure ownership in the initial stages, the reform plan should be simple to allow for input from the authorities as time evolves. Where capacity exists, the sequencing of reforms should reflect the priorities of the authorities. For example, the TA strategy in Lebanon assigned priority to tax policy reforms, consistent with the authorities' preferences. This garnered stronger ownership for the overall reform strategy. Furthermore, it is necessary to reach beyond the ministry of finance to ensure implementation of key measures. In the case of Afghanistan, more rapid progress in amending the income tax and customs codes would have been realized with earlier and more effective consultation with the ministries of commerce and justice. PEM reform would also have been more successful in that country with better collaboration between the ministry of finance and line ministries.
- **There is scope to improve donor collaboration.** The multitude of donors, coupled with weak administrative capacity, made collaboration difficult in some instances. For instance, in Timor-Leste assistance in implementing PEM reforms was being provided by more than one donor. However, PEM systems and traditions in donor countries were different, and personnel provided by them were not always familiar with each other's systems. This created problems in coordination. In Cambodia, the donor coordination mechanism was weak because it excluded key stakeholders such as tax, customs, and treasury directors. In Afghanistan, donors provided uncoordinated advice on energy taxation. There are several options for improving collaboration. First, the creation of a separate unit for donor coordination can help, such as in Kosovo and Mozambique. This can provide a vehicle for incorporating the

input of various donors in the design and implementation of the strategy and for the sharing of information, with a view to avoiding duplication and possible conflict. In cases where such a unit already existed, such as in Cambodia, FAD recommended strengthening of the coordination function through the appointment of a full-time national program manager. Second, the designation of a “lead donor” to ensure greater accountability was found useful. In several cases (Cambodia, Mozambique, and Yemen), FAD took the lead in coordinating donor assistance. And third, the establishment of steering committees to focus on specific areas in need of immediate attention has proved effective.²⁷ This was proposed in Afghanistan and Cambodia. While all these options can help strengthen collaboration, it is important that they are not viewed as panaceas.

- **Appropriate conditionality in Fund-supported programs can facilitate implementation of reforms.** This helped to raise the profile of these measures and focus the attention of the authorities on the steps necessary for their implementation. Program conditionality played a complementary role to the reform strategy in Afghanistan. The Staff-monitored Program (SMP) included a prior action for tax policy reforms and a structural benchmark for implementing a TSA. Likewise, some TA recommendations were incorporated as program conditionality in the DRC and Mozambique, which facilitated their implementation.
- **More effort by the international community needs to be directed at developing local capacity.** In all cases, weak institutional capacity was a major constraint in rebuilding fiscal institutions. In the initial stages, this was addressed through long-term resident advisors. This approach played a critical role in the DRC, although reforms slowed once resident advisors left. Donors also provided generous contributions for training. But developing local capacity proved more difficult than anticipated. This was the case in Mozambique. In many countries, slow progress reflected deep-seated problems in the civil service.
- **Progress in implementation has been slow in countries where the security situation is fragile.** In some cases, effective central government authority over the whole country was not established until well after the end of the conflict. This affected the implementation of TA recommendations. This was a particular concern in Afghanistan, where it took over two years to record improvements in the area of revenue administration. This reflected weak central control over provincial fiscal operations, resulting in the non-transfer of revenues to the central government. The security situation in DRC also slowed progress by delaying capacity building efforts for local fiscal institutions in former rebel-held areas.

²⁷ For discussion of a framework for collaboration among donors, including in cases where capacity is weak, see “Bank/Fund Collaboration on Public Expenditure Issues,” SM/03/73, February 2003.

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