INTERNATIONAL MONETARY FUND

Background Paper for "Rebuilding Fiscal Institutions in Post-Conflict Countries"

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Contents

List of Acronyms

EU	European Union
CIDA	Canadian International Development Agency
CFA	Central fiscal authority
DFID	Department for International Development
DGI	*Direction Générale des Impôts* (DRC)
DGA	Mozambique customs directorate
DNIA	Mozambique tax directorate
DRC	Democratic Republic of the Congo
ETA	East Timor Administration
FAD	Fiscal Affairs Department of the International Monetary Fund
FMIS	Financial management information system
IMF	International Monetary Fund
LEG	Legal Department of the International Monetary Fund
LTO	Large Taxpayers Office
LTU	Large Taxpayers Unit
OFIDA	*Office des Douanes et Accises* (DRC)
PEM	Public Expenditure Management
PETS	Public expenditure tracking survey
PSI	Pre-shipment inspection
QAG	Quality Assurance Group
SIPRI	Stockholm International Peace Research Institute
SISTAFE	Strategy for Public Expenditure Reform (Mozambique)
SIGTAS	Standard Integrated Government Tax Administration System
SMP	Staff-monitored program
TA	Technical assistance
TSA	Treasury single account
UNDP	United Nations Development Program
UNTAET	United Nations Transitional Administration in East Timor
USAID	United States Agency for International Development
VAT	Value-added tax

Introduction

This paper provides background information to "Rebuilding Fiscal Institutions in Post-Conflict Countries." The paper presents case studies on six countries—Afghanistan, Bosnia and Herzegovina, Democratic Republic of Congo (DRC), Lebanon, Mozambique, and Timor-Leste.

The information provided in this paper supplements the information presented in the main Board paper. The main paper discusses experiences in reestablishing fiscal management in post-conflict countries. On the basis of the Fiscal Affairs Department (FAD) technical assistance (TA) recommendations to these countries, that paper identifies key priorities for rebuilding fiscal institutions in a post-conflict setting. This background paper provides more detailed information for the six selected countries.

Each country case study provides a summary of FAD TA advice for rebuilding fiscal institutions and experience in implementation. A short description of the post-conflict environment is provided at the beginning of each case study to set the context in which FAD TA advice was given. This is followed, in most cases, with a short description of the overall strategy for rebuilding fiscal institutions. FAD TA recommendations for revenue policy and administration and public expenditure management (PEM) are then discussed separately. The issue of fiscal federalism and FAD TA recommendations on the subject are discussed in case studies for Bosnia and Herzegovina and DRC.[1] Successes and failures in implementing the recommendations are incorporated throughout the text. Each case study concludes with a description of the lessons from FAD's involvement in the country.

[1] This issue was also important in Croatia, which is not covered in the case studies.

Afghanistan

Afghanistan was ravaged by war and internal conflicts for more than 20 years. This led to a massive erosion of the government's capacity to provide public services. Whereas many formal institutions remained in place, a significant proportion of these ceased functioning due to lack of funding, qualified staff, and other resources. The legal framework for budget management was basically sound and many budget execution procedures were in line with good practices. However, there was little capacity in revenue administration departments where physical infrastructure and equipment had degraded significantly and the staff lacked the necessary skills. Proliferation of levies and taxes imposed by different government agencies and local authorities resulted in a complex tax system. Central control over provincial fiscal operations was very weak, resulting in non-transfer of revenues to the center. On the other hand, there were some well-established laws (e.g., tax and audit) that could provide a sound basis for rebuilding fiscal institutions. Nevertheless, the task was daunting as these systems were not operational in practice and needed to be updated and improved. Moreover, rebuilding fiscal institutions also required establishing a well-functioning payments system to facilitate tax payments.

The overall strategy for rebuilding fiscal institutions was designed by FAD through several technical assistance missions. In the PEM area, the legal framework for budget preparation and execution was basically sound at the end of the conflict, although it had not been applied for many years. Hence the strategy focused on implementing the existing framework. In the revenue area, however, emphasis was on both policy and administrative reforms. In the early stages, emphasis was placed on reforming customs policy and rebuilding customs administration. The strategy and the associated reform plans were endorsed by the authorities and the donor community. Hands-on implementation of the strategy was undertaken through very large TA programs financed by other donors. FAD has played a monitoring role to evaluate the implementation of reforms and to suggest improvements through follow-up missions.

Revenue policy and administration

Revenue policy and administration reforms aimed at simplifying the tax system and improving compliance and efficiency. In customs policy, reform measures included reducing the number of tariff bands from 25 to 6 and the use of a harmonized market exchange rate in customs valuation. Duty rates for certain excisable goods which were mostly imported (e.g., gasoline, diesel, cigarettes, and automobiles) were also raised. In domestic tax policy, the top marginal tax rate for individuals was reduced from 60 to 20 percent and the personal exemption was increased. Wage withholding tax was restored for high-income employees only. A simplified and generous depreciation schedule was also recommended to provide incentive for investment. Assistance in drafting tax law amendments has been provided by the IMF's Legal Department (LEG), which involved collaboration between officials from the ministry of finance and ministry of justice. The authorities have prepared five-year programs of direct and indirect tax policy reforms. Critical elements of these plans are supported by the Staff Monitored Program (SMP) for

2004/05, including elimination of generous tax holidays and exemptions that could seriously erode the tax base.

Key recommendations for improving revenue administration included: (i) measures to ensure transfer of provincial revenue to the center; (ii) establishing a Large Taxpayer Office (LTO) in Kabul and several model customs office; and (iii) extending improvements in tax and customs administration beyond the LTO and selected customs offices, starting from 2004. These measures have been incorporated in medium-term strategic reform plans for customs and tax administration designed with the assistance of resident advisors financed by donors. Some of these measures have been incorporated as benchmarks under the SMP.

Some progress has been made in modernizing tax and customs administration, in line with FAD recommendations. A taxpayer identification system has been put in place and the enforcement powers of tax officials have been enhanced. In the customs department, progress encompasses implementation of international standards for classification of goods, progressive recovery of customs functions from other agencies (e.g., valuation of goods), and replacement of multiple customs declaration forms with a single form for all types of imported goods. In both administrations, staff recruitment and training in priority areas have improved.

Public expenditure management

The strategy for strengthening the PEM system involved a two-stage process. The first stage aimed at promoting minimum standards of budgetary operations and reporting. Most FAD recommendations in this area were formulated within a coherent strategy with clear prioritization and sequencing. Weaknesses in budget execution were to be addressed through establishing a Treasury Single Account (TSA), improving cash management, and modernizing the chart of accounts. A simplified, centralized computerization of the PEM system was recommended in the initial phase to be gradually extended to the provinces at later stages. FAD recommendations also emphasized the importance of ensuring that donor funds were channeled through the budget and the treasury.

The second stage aimed at further progress in strengthening government financial management. One of the key recommendations was to implement a new budget law to address weaknesses in the PEM system that had come to light at a later stage following a more detailed analysis. Other recommendations included developing a complete and realistic annual budget, ensuring timely execution of the budget, and gradually introducing medium-term macroeconomic and budget projections. FAD, in consultation with the authorities and other donors, developed a two-year work program outlining the necessary steps for implementing the recommendations.

There have been substantial broad-based improvements in the PEM system in the last two years. Most of these improvements have taken place at the central ministry of finance; improvements in line ministries have been much slower. A TSA has been established, consolidating all government accounts; a computerized management information system has been set up in the ministry of finance and will be gradually rolled out to other parts of the government; donor-funded capital spending is increasingly being channeled through the treasury; and a public financial management law has been prepared and is expected to be approved shortly.

Lessons

Implementation of the strategy has been affected by the prevailing security situation in the country. The pace of reforms has been slow. For example, it took almost two years from the beginning of the reform process to record changes in the field in the area of revenue administration. This is partly due to the fact that the central government is facing the daunting tasks of establishing its authority over the territory and addressing severe security threats.

Inclusion of TA recommendations as conditionality in Fund-supported programs helped with implementation. Many of the tax policy reforms were implemented as prior actions under the Staff-monitored Program (SMP). Establishing the TSA was a structural benchmark under the program. The implementation of these measures was closely followed as part of program monitoring.

Flexibility in the overall strategy is important to respond to changing circumstances on the ground. The initial assessment underestimated some of the weaknesses of the PEM system, since the mission could not travel outside the capital on account of the prevailing security situation. The overall strategy was adjusted following detailed assessment by subsequent missions.

Progress was slowed by imperfect collaboration across government ministries. For example, in some cases, the ministry of finance fully supported and “owned” reforms, but the ministries implementing them (e.g., ministry of commerce and ministry of justice) were not fully on board. This resulted in slow progress in amending the income tax and customs codes. In part, this owed to the fact that in the initial stages, little effort was made to reach out to these ministries. PEM reforms (e.g., the TSA) could also have progressed more rapidly had line ministries been more involved at an early stage.

Good donor coordination is critical for success, especially when a large number of donors is involved. Coordination among donor programs is needed to ensure the optimum return from technical assistance. To secure this coordination, FAD recommended the creation of steering committees in the tax and customs administrations, and the appointment of a high-level independent project manager, to coordinate donor efforts under the five-year customs modernization plan. Nevertheless, there were several instances where donor coordination fell short of what was needed, with donors sometimes providing advice on the same topic (e.g., energy taxation) in an uncoordinated fashion.

Bosnia and Herzegovina

The new State of Bosnia and Herzegovina was formed in December 1995 with the signing of the Dayton Peace Agreement. In the immediate post-conflict period, many government structures did not exist, while those that did suffered significant damage. Moreover, the peace agreement mandated a decentralized government structure of eight local cantons, of which only two had functioning administrations at the time. As a result, the foremost priority was establishing the legal basis for fiscal institutions at all levels of government and making them operational. The task was further complicated by the fact that war-ravaged institutions that bore the stamp of a planned economy were to be transformed to support the move to a more market-based system. This made the task of institution building a formidable one.

FAD played a leading role in developing the overall strategy for rebuilding fiscal institutions. Key fiscal priorities in a range of areas were identified through diagnostic missions. The recommendations of the missions were presented in the form of a TA plan, with clear prioritization between immediate and short-term inputs, and clearly demarcated timelines for implementing them. Detailed descriptions of TA inputs as well as the terms of reference for resident advisors required by this TA program were also provided. It was recognized from the very beginning that the implementation of the program would have to depend on support provided by other donors.[2]

Fiscal federalism

FAD recommendations provided a roadmap for critical decisions relating to inter-governmental fiscal relations, given the consensus on a highly decentralized state. The peace agreement assigned power to the entities to determine tax policies. In its recommendations, FAD advised governments to make clear decisions about lead players in areas of overlapping jurisdictions, and decide on approaches to resolve differences when they arose. Flexibility was recommended in setting revenue and expenditure assignments in the initial period while emphasizing the need for identifying a transparent revenue-sharing agreement for the cantons. In addition, tax policy among different entities needed to be harmonized, as much as possible, to avert harmful tax competition that could distort the distribution of productive resources, and raise taxpayers' compliance costs. Intergovernmental transfers were recommended to mitigate horizontal and vertical imbalances among regions. Fiscal rules limiting borrowing by cantons were recommended.

[2] The Department for International Development (DFID), the European Union (EU), and the United States Agency for International Development (USAID) provided substantial assistance for implementation of TA recommendations.

Revenue policy and administration

Revenue administration recommendations aimed at establishing viable revenue collection systems. A strong role for the central government as a revenue collector was recommended to exploit economies of scale and to provide a harmonized tax environment, especially in the context of the planned implementation of a value-added tax (VAT). FAD has also provided TA to support VAT implementation. Initial recommendations focused on managing the transition from the retail sales tax to an eventual VAT system consistent with EU standards. Assistance was also provided for the establishment of a single customs body at the state level and for establishing an Indirect Tax Authority and the associated Governing Board. The rapid implementation of a taxpayer identification system was recommended, along with an action plan for modernizing the tax administration through computerization. A common customs administration was strongly advised. The creation of a Tax Board representing the federal government, the cantons and the federation/republika to harmonize procedures, tax forms, the tax base and rates and formulate joint tax policy was suggested.

In the area of tax policy, FAD recommended a federal level corporate income tax. It was argued that this would prevent evasion, avoid harmful tax competition, minimize distortions in resource allocation, and facilitate the negotiation of international tax treaties and horizontal equity for taxpayers in different regions. The personal income tax was to be retained at the local level to reflect regional preferences and income patterns.

Despite the difficult conditions in which the reforms took place, there was progress in reforming customs administration. This included: (i) the merger of the existing customs administrations of the Bosniac-majority and Croat-majority areas into a centralized Federation customs administration; (ii) the removal of internal borders between the Bosniac-majority and Croat-majority areas; and (iii) the adoption of a unified external customs tariff. By late 1999, the customs administrations of the two Entities (Federation and Republika Srpska) had completed a comprehensive modernization process with substantial EU support.

Progress with tax administration reforms has been slower. However, two main objectives were achieved in the immediate post-conflict period. In the Federation of Bosnia and Herzegovina: (i) a tax administration law was prepared and approved, establishing the legal basis for the organization and operations of tax administration; and (ii) the existing tax administrations of the Bosniac-majority and Croat-majority areas were formally merged into a centralized Federation tax administration. The Republika Srpska’s tax administration, customs administration, and financial police were merged into the ministry of finance, and several measures were implemented to improve the effectiveness of tax administration.

Administrative reforms led to tangible increases in tax revenues. By mid-1996, the budget of the Republika Srpska was approximately balanced, based partly on improvements in tax collection. At the Federation level, revenue performance from customs and excise tax collections was strong, which enabled the Federation to maintain a significant fiscal surplus during the first half of 1996.

Public expenditure management

In the PEM area, recommendations were couched in terms of immediate needs, and then more medium-term capacity-building requirements. The recommendations addressing immediate needs focused on three broad objectives. The first objective was to ensure adequate macroeconomic control mechanisms to stabilize the economy and limit the inflationary impact of large foreign inflows in the context of a crippled productive base. Recommended actions to achieve this included broadening the institutional input in the development of macroeconomic policy at the State level, establishment of a cash management unit at the Federation level to ensure that revenues and expenditures were balanced, and the establishment of fiscal rules to prohibit borrowing at the cantonal level at least in the early years. The second objective was to enable the new administration to utilize as fast and as effectively as possible the substantial expected inflows of foreign assistance for reconstruction and development. Recommendations in this area included the establishment of a ministry for reconstruction and development to manage the linkages between donor funding and the different levels of government, developing an action plan for reconstruction with technical assistance, and developing a viable institutional structure for fiscal management at the cantonal level. The third objective was to transform war-ravaged institutions from those that were more appropriate for a planned economy to those supporting a modern market economy. To achieve this, a framework for the budget process needed to be developed and immediate improvements in budget preparation and execution techniques were recommended.

The medium-term objectives were two-fold in their focus. The first objective was to put in place a workable budget system for the Federation. Towards this end, an organic budget law was recommended to provide the legal framework for budgeting. In addition, importance was placed on strengthening the institutional framework for preparing and executing budgets in the context of the reorganized Federation. Concurrently, budget preparation techniques were to be strengthened through such mechanisms as better budget classification and improved analytical capacity in the budget department. The second objective was to establish a treasury department to improve budget execution. The treasury department would exert control over government payments, account for their use, and manage government cash resources. The approach in this area was to initially preserve as much as possible those elements of the existing system that were workable, and to take the existing practices and reformulate them, so that a treasury system could become operative as soon as feasible. It was envisaged that the payments bureaus could serve as an elementary treasury system in the initial period. A TSA was recommended for consolidating government cash balances and guiding the execution of the budget through a process of cash planning.

The PEM system improved considerably, slowly at first but then at an accelerating rate. An Organic Budget Law was introduced in 1998, spelling out the role of the treasury. A TSA and general treasury ledger were established in 2000. Regulations on budget accounting were introduced later in the same year. Financial regulations regarding the chart of accounts, financial reporting, and annual accounts were issued in the following year.

Lessons

Good collaboration among different TA providers is essential to any successful rebuilding exercise. While FAD recommended a gradual approach to dismantling the existing treasury system, other TA providers advocated a big-bang approach. However, good donor coordination ultimately resulted in a unified stand on the issue. In the end, the adopted big-bang approach was not as disruptive as FAD had feared, mainly because the different TA providers collaborated extensively to ensure the success of the transformation from the old payments system to a modern treasury system.

The implementation as well as sequencing and prioritization of reforms should take into consideration that some reforms take more time than others. For example, in the PEM area it is possible to establish an expenditure control system in a much shorter time frame than analysis and policy development capacity. In the case of Bosnia, an effective budget execution system incorporating a TSA was established reasonably quickly, while progress in fiscal policy development and in enhancing budget analysis skills has been much slower.

Country ownership determines the pace of implementation of reforms. Progress in tax policy reforms was slower precisely because in the initial stages ownership of reforms was weak. In particular, it took some time for the political leadership in the two constituent entities of the country to come to an agreement on the distribution of powers regarding tax policy and administration. In a similar vein, implementation of PEM reforms also got off to a slow start although the pace picked up subsequently.

Democratic Republic of Congo (DRC)[3]

The end of the civil war in the DRC was marked by a vicious circle of hyperinflation, a depreciating currency, and general impoverishment of the population. The primary factor behind this was the monetization of an uncontrolled budget deficit resulting from the collapse of the expenditure control system and of revenue collections. By 2001, the expenditure management system had experienced a dramatic deterioration: a large part of government revenue collection and expenditure operations was being carried out outside the treasury, and government expenditure was no longer being reported in an orderly fashion. The poor revenue performance resulted from a complex tariff and tax system and a narrow tax base resulting from numerous exemptions and discretionary measures. Significant weaknesses in the revenue agencies also resulted in poor tax compliance.

The Fund took the lead in designing the overall strategy for rebuilding fiscal institutions in the DRC. The strategy was formulated while the conflict was still ongoing and about half of the territory was under government control. An initial multi-topic mission in March 2001 was followed by specialized missions to design reform strategies and identify TA needs. Assistance was provided in the form of: (a) a strong resident technical assistance program, and (b) regular follow-up missions to assess reforms and provide further guidance. The World Bank has also provided substantial support to complement the work of the IMF.

Revenue policy and administration

On the revenue side, efforts focused on strengthening revenue administration capacity before introducing policy reforms. The strategy for strengthening revenue administration was implemented in two phases. The first phase included measures to strengthen the customs and tax departments (*Office des Douanes et Accises* (OFIDA) and *Direction Générale des Impôts* (DGI) and set up a Large Taxpayers Unit (LTU) for the 500–600 largest taxpayers (accounting for about 70 percent of total tax collections).

The objective of the first phase of reforms was to restore the administrative capacity to collect revenue from major revenue sources, before extending the reforms to the whole country and to all taxpayers. The reorganization of the DGI headquarters was achieved in early 2003 and LTU operations began in March that year. Modern organizational principles and simplified collection procedures, supported by new computer systems, were introduced in the LTU at its inception (e.g., self-assessment and payment through banks). During the same period, customs administration reform focused on (i) introducing a basic management system (to provide statistical information and to monitor customs exemptions), and (ii) the establishment of a pilot customs office in Matadi (the DRC's main port of entry) to introduce

[3] For a comprehensive discussion of the case of DRC see Clément, Jean A.P. (editor), 2004, *Postconflict Economies in Sub-Saharan Africa—Lessons from the Democratic Republic of the Congo* (Washington, DC: International Monetary Fund).

a new organizational structure and simplified procedures and systems (including the ASYCUDA computer system).

The second phase began in 2003, with the aim of expanding new organizational principles, procedures, and systems to the entire revenue administration. Relying on the modern processes developed in the LTU and the pilot customs office, the program aims to (1) restructure the network of local tax offices; (2) modernize the customs organization and procedures; and (3) expand progressively the DGI and OFIDA modernization efforts to other regions, following the installation of a government with control over the entire country. The DGI is preparing for establishment of medium-size enterprise centers in Kinshasa, and OFIDA has plans for restructuring and computerizing new customs offices in Kinshasa and Lubumbashi areas with technical assistance support. Implementation of this second phase is only at an early stage as organization and procedures in the model offices have to be strengthened further.

Tax policy reforms were introduced in March 2003 after the first phase of revenue administration reforms was completed. The custom tariff structure was simplified by reducing the number of rates from 5 to 3 and by eliminating the surtax applied to specific products. In the area of indirect taxation, the turnover tax was reformed by reducing the applicability of the concessionary rate only to investment goods and agricultural inputs and extending the standard rate to all other products, and by authorizing enterprises to deduct the turnover tax paid on their inputs. At the same time, the standard rate was extended to all products subject to excises, and the petroleum product price structure was simplified.

Public expenditure management

A gradual approach was adopted for strengthening the PEM system. The first steps were intended to address the most critical shortcomings in the management capacity of the government’s financial operations in an environment where a priority of the government was to curb the budget deficit in order to fight hyperinflation. They included, in particular, centralizing all revenue and expenditure in the treasury account at the central bank and restoring the authority of the treasury to control and monitor all payments.

These actions were complemented by the establishment of a medium-term strategy for the rehabilitation of the PEM system, implemented with the assistance of the long-term resident expert. This strategy aimed at restoring an orderly budget process and facilitating the reporting of government expenditure, and included the adoption of a comprehensive and realistic budget, the implementation of streamlined budget execution procedures, the monitoring of a monthly cash flow plan, regular data reconciliation and reporting mechanisms, streamlining of government bank accounts, and the implementation of a simple government accounting framework.

Significant progress has been made to reestablish proper budget management at the central level: (i) revenues and expenditures are now centralized in the Treasury Single Account; (ii) a new budget classification has been implemented that allows for identification of poverty-reducing spending; (iii) budget execution procedures have been streamlined and partially automated; and (iv) cash reconciliation and management has improved substantially. Improvements are noticeable in all areas of the PEM system, but relatively more in budget formulation and reporting than in execution.

Fiscal decentralization

FAD also provided advice on the institutional framework for fiscal decentralization. Given the collapse of local administrative and institutional capacities, the government was advised that decentralization should be viewed as a gradual process. Furthermore, to help evaluate progress and guide this process, it was suggested that an institutional mechanism be established. Toward this end, the mission recommended creating a commission in the senate and at the assembly to deal with decentralization issues. To facilitate coordination among different government ministries and agencies, as well as to set objectives, a working group composed of the ministers of finance, budget, and interior as well as the provincial governors was also proposed.

FAD TA recommendations also focused on the legal framework for intergovernmental fiscal relations. It was recommended that the assignment of responsibilities be the core of any decentralization law. Any transfer of responsibilities would be firmly linked to progress in reinforcing local administrative and institutional capacities. Given the gradual approach recommended, FAD advised that the revenue transfer rate not be explicitly stated in the decentralization law, but in the budget law every year. The transfer of revenue would be linked to the transfer of expenditure responsibilities.

Lessons

Diagnostic missions in specialized areas were helpful in designing the overall strategy and identifying TA needs. A medium-term strategy with appropriate prioritization and sequencing of actions was drawn up for both revenue and expenditure reforms. In the course of the process, the overall strategy was partially redirected in order to take into account the actual pace of reforms, emerging priorities (such as the need to track poverty-related expenditures and possible decentralization) as well as the identification of additional weaknesses. This also emphasizes the need for early and regular follow-up missions in a situation where conditions on the ground are evolving rapidly.

The role of the resident advisors was critical in rebuilding fiscal institutions in the DRC. Given weak initial technical capacity within the ministry of finance and limited involvement of other donors, hands-on assistance provided by FAD through the posting of a resident advisor was essential for the effective implementation of TA recommendations. However, progress with reforms stalled once resident advisors left.

Greater priority should have been accorded to budget preparation and accounting. The TA program paid excessive attention to providing hands-on assistance to the implementation of the budget execution and reporting system to the detriment of other areas. For example, until 2001, the adoption of the annual budget was not completed until late in the year, if at all. This diminished the role of the budget in allocating and prioritizing government spending. A better balance in TA would have resulted in more assistance to areas such as budget preparation, leading to faster progress in these areas.

Close monitoring within the framework of a Fund-supported program helped in the implementation of TA recommendations. Some of the recommendations were included as conditionality in Fund-supported programs. Others, though not formal conditionality, were key elements of the authorities' program, and their implementation was monitored as part of the Fund-supported program.

The strength of the authorities' commitment was a key factor in successful implementation of measures. Little progress was made in the period preceding the nomination of the transition government. Technical assistance was effective only when institutional resistance waned and political commitment to reform was reiterated by the transitional government.

Decentralization should proceed in tandem with progress in developing capacity at local levels. In cases, where institutional capacity at the subnational levels is weak, a gradual approach to fiscal decentralization may be appropriate. This also highlights the importance of efforts aimed at strengthening local institutions.

Lebanon

Lebanon's sixteen-year civil war exacted a heavy toll in human and material terms. Its public finances deteriorated significantly, owing to the lack of central government authority and inability to collect revenues. Following the 1989 Taif Accord for National Reconciliation, government authority was gradually restored, and hostilities came to an end in 1990. Towards the end of 1991, with political stability returning, the authorities began the difficult task of postwar reconstruction and development, including rebuilding the fiscal institutions. Consistent with the authorities' preference, early efforts focused on rebuilding the tax system. It was only later that the effort was extended to the PEM area.

Revenue policy and administration

Rehabilitation of the tax system focused initially on customs and domestic tax policy. The strategy was to raise government revenues quickly by relying as much as possible on the existing tax system. Revenue administration capacity, though diminished due to the conflict, was deemed capable of implementing the existing system. Therefore, initially, TA tended to be in the policy area—it was some time later that the reform effort shifted, in a significant way, to reconstruction of revenue administration. Even in revenue policy, the initial emphasis was on reform of existing tax instruments rather than introduction of new ones (such as the VAT).

Tax and tariff reforms were progressively introduced from 1993 onwards. The reform of taxes on income and profits aimed at encouraging investment and improving taxpayer compliance by reducing high rates. Tariff reform in 1995 simplified the tariff structure through consolidation of charges and duties, and lowering of rates. To boost revenues, excises were also increased, especially those on tobacco, cigarettes, and petroleum products.

Collectively, these policy initiatives contributed to an increase in the tax-to-GDP ratio from 9.3 percent in 1993 to around 14 percent in 1996.[4] Of equal importance, they laid the foundation for later reforms, including introduction in 2001 of a new customs law (including valuation provisions consistent with the World Trade Organization valuation agreement), and a VAT in 2002. A further major policy reform—a global income tax to replace the current scheduler taxes—is planned for 2006.

Efforts to rehabilitate revenue administration commenced in 1995. The customs department embarked on a modernization program that was to span the next several years. Under this program, customs procedures were simplified and automated, and a self-assessment approach to the release of goods was introduced at ports of entry. FAD assisted the authorities to refine these procedures and approaches, particularly in relation to the post-release compliance program.

[4] With serious problems faced by the economy in the period 1997 to 2001, the tax-to-GDP ratio subsequently dropped to an average of around 13 percent.

Computerization of revenue administration was an important element of the rehabilitation program.[5] This was intended to provide impetus for badly needed administrative reforms, given low levels of tax compliance and generally weak tax administration at the time. However, little advantage was taken of the capabilities offered by the system until the introduction of the VAT in 2002. The newly created VAT administration successfully utilized the computer system, and reaped the gains of a function-based organizational structure that improved the efficiency of tax administration. The introduction of the VAT and the associated administrative reforms have contributed to an increase in the tax-to-GDP ratio.[6] However, income tax revenue yields remain extremely low, suggesting significant tax evasion and an inefficient income tax administration. Consequently, FAD has recommended that a comprehensive modernization program be mounted to cover all areas of revenue administration.

Public expenditure management

Efforts to strengthen the PEM system began in early 1993. FAD prepared the overall strategy and a set of specific recommendations for improving budget formulation, execution, and reporting. These included introducing a new budget classification, computerizing budget execution, and revising the Budget Law. A United Nations Development Program (UNDP) project assisted the authorities with computerization. Financing for this effort was also provided by the World Bank. FAD provided a long-term advisor who prepared a new budget classification, updated the accounting framework, and advised the UNDP team on computerization.

The implementation of PEM reforms has been mixed. Progress has been made in improving the transparency of budget execution. A new budget classification has been implemented and monthly reports of budget and treasury operations are prepared and published. Weekly reconciliation of fiscal and monetary accounts is being undertaken. However, the budget law has still not been revised; the draft legislation has been pending in Parliament for over four years. While some improvements have been made to enable the ministry of finance to "manage" the spending process, there is still considerable discretion in this regard, and the budget process remains disjointed.

Lessons

Sequencing of reforms in accordance with country priorities makes them more likely to be implemented. The overall strategy focused first on tax policy reforms in accordance with

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[5] The Canadian International Development Agency (CIDA) provided the majority of support in this area, including financing for the new computer system SIGTAS (Standard Integrated Government Tax Administration System).

[6] The tax-to-GDP ratio increased to more than 16 percent by 2004.

the authorities’ preference. This led to greater country ownership of the strategy which facilitated their implementation. Where sequencing according to the authorities’ preferences is not possible due to the nature of the reforms or conditions on the ground, the rationale for the proposed sequencing should be explained to the authorities to obtain their concurrence and support.

Mozambique

The protracted civil conflict in Mozambique lasted for more than ten years. Although peace negotiations started as early as 1992, when a provisional cease-fire went into effect, the General Peace Agreement was successfully concluded only in 1994. Democratic institutions were established in December 1994 with the convening of the parliament and the formation of a government by the newly elected President of the Republic. At that time, revenue administration in Mozambique was extremely weak. Both the tax directorate (DNIA) and customs (DGA) were in dire need of reform, particularly the latter, which was unable to enforce payment of duties and taxes and to control widespread smuggling.

The overall strategy for rebuilding fiscal institutions, designed by FAD, adopted a phased approach, focusing first on the most pressing problems. In the case of tax policy, the first phase consisted of tariff reforms. The second phase addressed issues related to the indirect tax system, while the reform of direct taxes was left for the third phase. In the area of revenue administration, problems related to customs administration were to be addressed first. Based on available diagnostic studies, action plans were drawn up for both customs and domestic tax administration reforms, and to begin planning for the implementation of a modern VAT. The latter would only be implemented over the medium term. The authorities decided to seek assistance from other donors besides the Fund and the Bank for the implementation of the reforms. Overall coordination in the fiscal area, however, was to remain the responsibility of the Fund.

FAD was not involved in the PEM systems in the immediate post-conflict period, as other donors were active in this area. In 2001, an administrative unit—UTRAFE—was created within the ministry of finance to coordinate PEM reform. Later in the year, a Strategy for Public Expenditure Reform—SISTAFE— was launched with the objective of integrating and standardizing the budget, treasury and accounting information, and improving budget coverage, cash management, and the chart of accounts. The government found it difficult to deal with many different donors providing different recommendations and in 2001 requested the Fund to coordinate and lead the process of PEM reforms. A basic framework for PEM reforms was prepared by FAD in 2002, following a diagnostic mission, and is currently being implemented.

Revenue policy and administration

Revenue policy recommendations focused on removing distortions, simplifying the tax system, and eliminating disincentives to private investment. The reform of the tariff structure involved both a reduction in the rates as well as in the number of tariffs. A VAT was recommended, along with selected excises, to replace cascading turnover and consumption taxes. More recently, FAD has provided recommendations for reform of direct taxes, following a comprehensive review of the direct tax system. LEG has also been involved in assisting the authorities draft tax legislation, drawing on experts with a background in the Portuguese legal traditions that influence the Mozambican system.

Reforms of revenue administration aimed at complementing policy reforms, reducing evasion, and enhancing compliance. Measures were recommended for a comprehensive reform of customs management, with a view to reducing evasion. A key recommendation was the introduction of preshipment inspection (PSI) and privatization of the customs management. A new VAT service was to be set up, along with a new computerized VAT support system. Preparations are also underway for setting up a Central Revenue Authority by 2005.

Significant progress has been achieved in transforming the Mozambican tax system and its administration. The tariff structure was simplified by reducing the number of tariff levels from 24 to 8 in the first stage and then to 5; the maximum tariff rate was reduced from 105 percent to 35 percent in 1996 and to 30 percent in 1999. A VAT was introduced in the same year. New personal and corporate income taxes were introduced in 2003. In customs administration, a new and more effective PSI arrangement was introduced in 1996. A comprehensive private customs management and reform project was initiated in 1997, which has resulted in a noticeable increase in customs revenues. Customs operations were gradually handed back to Mozambican staff during the period 2000–2002. In domestic tax administration, a new VAT service, organized along functional lines and staffed with newly recruited professionals, was created within the DNIA; new audit procedures were developed and put in place by a small number of newly recruited tax auditors; and new computerized VAT support systems were implemented in Maputo. Institutional capacity of the revenue administration has improved and taxpayer compliance levels have significantly increased. Both are now more or less at par with regional averages. Implementation was also facilitated by incorporating several reform measures as benchmarks and performance criteria in Fund-supported programs.

Implementation of the strategy resulted in significant increase in government revenues. Total tax revenue increased from about 9.6 percent of GDP in 1994 to about 14.3 percent in 2003, in spite of the revenue losses stemming from tariff reform and other changes in the tax system that eliminated distortions. The authorities are targeting a tax/GDP ratio of 15 percent by 2006.

Public expenditure management

The basic framework for PEM reforms, in the context of the SISTAFE, was prepared in early 2002, following an FAD diagnostic mission. The reform program was to be implemented over a five-year period, with the objective of strengthening budget formulation, execution, and reporting. Early actions were recommended for developing a new chart of accounts, improving budget execution procedures, and introducing a financial management information system. A TSA was recommended to consolidate all government revenues and expenditures. Over the medium term, the main recommendations were to update budget management practices to improve transparency and efficiency and strengthen budget control. Another key measure was to gradually extend budget coverage by incorporating own revenues of entities and all foreign grants and credits into the budget. The 2005 budget will include, for the first time, own revenues of some line ministries and expenditures funded by them.

There has been considerable progress in the development of the budget execution and treasury systems. To strengthen the management framework for the reform process, a local project manager was appointed in early 2004, with special responsibility for detailed project planning and monitoring of progress, as well as for establishing a coherent risk management framework. The authorities have taken important steps to consolidate government bank accounts. Progress has been made in developing a financial management system and setting up a TSA. Beginning in November 2004, the central and branch officers of the ministry of finance have begun the financial execution of the budget through a basic version of the information management system (e-SISTAFE). Rollout of the system to line-ministries is expected to begin by mid-2005.

Lessons

The initial implementation schedule for PEM reforms was unrealistically ambitious. The reform process has encountered delays and setbacks, which led to several revisions to the timetable for reform. The current timetable is still very tight, but clearly more realistic than the initial one. The establishment of UTRAFE has been a very important step.

Domestic institutional capacity has remained a constraint throughout the period. Identifying and recruiting suitable professionals has proved more difficult than anticipated. Training needs were very high; even generous donor contributions could not overcome these constraints, given the limited absorption capacity of the staff. The slow pace of the overall civil service reform effort has also contributed to delays in the establishment of a satisfactory revenue administration.

Strong government commitment and good coordination among donors have been important factors in determining the pace of reforms. Government commitment to the reform process was strong from the beginning, and remained so throughout. Donor support has also been strong since 1995. In this context, UTRAFE has played an effective role in coordinating donor inputs in a meaningful manner. A Quality Assurance Group (QAG) has also been established to identify specific weaknesses and risks in the organization and implementation of the PEM reform program. While some donors initially resisted coming under the UTRAFE umbrella, there is now universal acceptance (evidenced by progressive unanimity in the QAG assessments) that this coordination is a very important element to ensure sustained progress with institutional reforms in Mozambique.

FAD resident advisors can play a useful advisory role in catalyzing reform. In the absence of sufficient local capacity, several advisors were appointed to assist in the implementation of the reform program. They have focused on providing advice regarding improvements in core financial management functions and systems but did not get directly involved in broader public administration reforms. This enabled them to play their role more effectively and contributed to the progress in rebuilding fiscal institutions.

Incorporation of concrete reforms as benchmarks or performance criteria in Fund-supported programs can facilitate implementation. This helped raise the profile of these measures and focus the attention of the authorities on the steps necessary to improve the tax system.

Timor-Leste

Widespread violence in the wake of the August 1999 independence referendum led to extensive damage and destruction of physical infrastructure, displacement of the population, and loss of life. In late October 1999, the United Nations Transitional Administration in East Timor (UNTAET) was established for administering the territory during its transition to independence. No permanent structure was in place that could effectively prioritize spending according to even basic principles, nor was there any spending accountability in place, beyond standard UN procedures. Therefore, the formidable challenge was to create a working ministry of finance that would be responsible for a consolidated budget for the East Timor Administration (ETA). Reestablishing the government's revenue collection capacity was an immediate priority. Towards this end, a coherent tax system needed to be established along with a new revenue administration. Urgent measures were required to establish public expenditure management and treasury operations, virtually from scratch, within a very tight timetable. UNTAET needed to put these institutional capacities in place very quickly in order to manage public services and reconstruction effectively.

Reestablishing fiscal operations

Making the Central Fiscal Authority (CFA) operational was the first element of the strategy to establish fiscal institutions in Timor-Leste. FAD provided the framework for the development of the CFA. It was envisaged that the entity would design the overall fiscal strategy, formulate tax policy, administer revenue collection, and coordinate the public expenditure program, including the control and execution of public spending. The CFA would consist of four departments: a budget department to formulate the budget; a treasury department to execute the budget; a tax administration department responsible for domestic revenue collection; and a customs department responsible for raising revenue from import taxes. In the initial stages, it was recommended that revenue administration departments also take responsibility for revenue policy formulation. An interim set of procedures to execute expenditures was also implemented, with a view to achieving a minimal degree of transparency and accountability until the CFA became fully operational.

In the initial stages, the CFA was to be largely staffed by international experts. Prior to independence, most of the staff in the fiscal institutions were Indonesians who left following the 1999 referendum. There was little local capacity to staff the new institutions. Initially, therefore, the departments of the CFA were headed by expatriate staff financed by donors. The next step was to recruit and train the Timorese to enable them to take over the day-to-day activities of the CFA.

Revenue policy and administration

Revenue policy recommendations aimed at establishing a tax system that was fair and transparent as well as simple to administer. The objective was to generate sufficient revenue to cover one-half of government current spending in the first year and most of the recurrent budget by the end of the third year.[7] The proposed tax structure included: a single rate customs duty; a sales tax on imports; a service tax on hotel and restaurant receipts and housing and vehicle rentals; various excises; a wage withholding tax; and a presumptive income tax on coffee exports. An interim structure of fees, such as on airport departure and car registration, was also proposed. User charges were recommended for public utilities and use of airport and ports based on cost-recovery principles. Not all these measures were successful, however; the presumptive tax on coffee exporters had an unduly depressing effect on the sector in the wake of sharply falling international prices, with revenue from this tax becoming negligible. In the end, the tax was abolished by the authorities.

The rapidly changing legal environment posed a challenge to securing changes in tax legislation. The new tax laws were prepared with the assistance of LEG. During the period of UN administration, for example, Indonesian law continued to apply. Thereafter, the adoption of Portuguese as the official language required that close attention be paid to Portuguese version of the laws. Frequent personnel changes among counterpart officials also complicated the process.

FAD provided operational support for setting up a new revenue administration. A Commissioner was assigned to secure and lead a team of experts engaged by other donors,[8] and to develop the administrative framework required to: (i) support a domestic tax collection system based on the principle of self-assessment. This involved providing legislative drafting assistance, designing structures, systems and procedures, engaging local staff, and conducting training and public education campaigns; (ii) facilitate the collection of revenue from the Timor Sea participants (mainly multinational oil companies); and (iii) oversee the day-to-day management of the revenue administration department. Procedures were recommended for identification and registration of taxpayers and the setting up of an LTU. FAD also provided assistance in establishing procedures for filing and payment of taxes, collection enforcement, and developing an audit function.

A fully functional tax administration was developed by mid-2003. By the conclusion of FAD's involvement, an appropriate tax law was in place, a full set of processing systems had been developed, and a nearly complete IT system was installed. Taxpayers had been registered, tax returns were being filed, and revenues were being collected. The department had recruited sufficient Timorese nationals to manage the system. At the same time, extensive training was being delivered. Auditing and arrears collection operations were also being undertaken, and a basic taxpayer service was functioning. The number of Timorese nationals managing the system increased, but significant work is still needed to fully develop the local staff's capacity.

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[7] See Valdivieso, Luis, and others, 2000, *Timor-Leste: Establishing the Foundations of Sound Macroeconomic Management* (Washington, D.C., International Monetary Fund).

[8] UN, AusAID and CIDA.

Public expenditure management

A key objective of the PEM recommendations was to establish a treasury system that would meet international standards for efficiency, accountability and transparency. Institutional structures and procedures needed to be developed for managing revenues and expenditures, as well as assets and liabilities of the ETA. A comprehensive and reliable Financial Management Information System (FMIS) was also needed to enhance fiscal reporting and support the efficient execution of the budget. With this end in view, FAD recommended setting up a Treasury Single Account (TSA). FAD has also worked closely with LEG in assisting with the drafting of the Budget Law. A capacity building plan for the ministry of planning and finance was also designed with FAD's help. Assistance in budget preparation was provided through the services of a resident advisor in 2002.

The core expenditure management system in Timor-Leste compares favorably with that of other low-income countries. A recent assessment carried out by the World Bank concluded that the PEM system meets 12 of the 15 benchmarks used for assessing the capacity of the system to track poverty-reducing spending.[9] The assessment noted that further improvements were needed in expenditure classification, identification of poverty-reducing spending, and public expenditure tracking surveys (PETSs) to ensure that funds were being used as intended. The biggest weakness of the system was poor budget execution, with significant and consistent underspending in priority areas.

Lessons

The overall strategy of integrating several revenue administration activities into a single agency was beneficial. The near-absence of any tax policy, tax law, or tax administration capacity meant that it was possible to integrate activities relating to legislative drafting, process design, and policy development and implementation into a single agency. By so doing, a working tax administration was established in a remarkably short time.

The external environment can affect the success of tax policy measures. The decline in international coffee prices, for example, resulted in the presumptive income tax on coffee having a more adverse effect on the sector than envisaged.

The strong lead role taken by UNTAET to reestablish the fiscal system enabled rapid progress to be made in the period prior to independence. The pace of reform slowed afterward, however, reflecting the limited capacity of local staff and the waning availability of suitably qualified international experts (including with the requisite language skills) to assist the ministry of planning and finance.

[9] See World Bank, *The Democratic Republic of Timor-Leste: Public Expenditure Review*, July 2004.

Donor support was crucial in rebuilding fiscal institutions. Several donors were involved from the start and provided experts who were instrumental in designing and administering the basic processes, while providing training to locally recruited staff. This international support proved to be crucial, as domestic capacity constraints were significantly greater than expected. Coordination of donor TA was, however, problematic in the PEM area. PEM systems and traditions in donor countries are different, and personnel provided by them were not always familiar with each other's systems.

In the PEM area, FAD's support was focused on developing the basic treasury system, and to assist in developing a budget preparation function. The development of basic treasury operations helped demonstrate to donors (especially the UN) that, while rudimentary, a well-functioning public expenditure management system was in place.