Peace and the Public Purse

Economic Policies for Postwar Statebuilding

edited by

James K. Boyce and Madalene O'Donnell

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—James K. Boyce and Madalene O'Donnell

Contents

policies must be recast in light of the political dynamics of war and peace. A third view takes the opposite stance: the political and security dimensions of peace processes ought to be realigned to reflect the realities of public finance.

This book makes a compelling case for reshaping *both* economic policies and peacebuilding assistance in light of their mutual interdependence. The authors suggest that economic policies for managing the public purse can and must do more to meet the political and security challenges of war-to-peace transitions. At the same time, they suggest that external assistance for peacebuilding must do more to address the fiscal challenges of statebuilding. The task is complicated by the division of labor among international actors, in which the international financial institutions (IFIs) specialize in economic matters while the United Nations and other providers of peacebuilding assistance address political and security issues. Building a legitimate state and forging a durable peace require new thinking on both fronts: a fundamental reappraisal of what constitutes "sound" public finance and equally profound changes from "business as usual" in the policies and practices of international peacebuilding efforts.

The book presents six case studies plus two topical chapters, all of which explore the relationship of public finance to the dynamics of peacebuilding and statebuilding. The case studies—Uganda, Cambodia, Guatemala, Timor-Leste, Afghanistan, and Palestine—were chosen to reflect diverse initial conditions, varying lengths of time since beginning peacebuilding assistance, and different relationships to the international geopolitical environment. These studies focus on the core issues of revenue mobilization, budget allocation, and expenditure management. The two topical chapters focus on closely related issues: postwar monetary policy, drawing in particular on experiences in Afghanistan, Bosnia, and Kosovo; and postwar external debt management, drawing on experiences in Uganda, Mozambique, and Democratic Republic of Congo.

Postwar Environments

This book is premised on the belief that postwar countries often share important features in common—notably a mismatch between fiscal capacities and needs as well as ongoing societal tensions that could precipitate the renewal of violent conflict. Yet there is also a great deal of diversity in postwar environments, and it is important to consider the differences among them in formulating public finance policies. One lesson of the experiences reviewed in this book is that even though knowledge of other postwar experiences is a great asset, off-the-shelf solutions cannot be imported from one setting and simply grafted intact into another. Among the key axes of differences in postwar environments are the following:

- The *type of transition and the resulting balance of power* among contending parties: A winner-take-all victory as in Uganda or a successful independence struggle as in Timor-Leste presents different postwar political dynamics than a negotiated settlement that leads to power-sharing arrangements, as in Cambodia.
- The *level of economic development:* Some countries embark on postwar peacebuilding with extremely low per capita income and human development indicators, low levels of macroeconomic stability, or very low ratios of revenue and expenditure to gross domestic product (GDP); others start from a more favorable economic position in one or more respects.
- The scale of *external assistance:* In some cases, as in Timor-Leste and Afghanistan, postwar aid inflows are massive in relation to the local economy, particularly the "formal sector" of the economy; in others, as in Guatemala, aid is modest relative to both national income and the government budget.
- The role of *natural resource extraction and narcotics:* If natural resources or illicit narcotics—such as timber in Cambodia or opium in Afghanistan—are important as sources of financing for armed groups, this poses special problems at the interface between security and public finance.
- The *fault lines of conflict:* When differences along lines of ethnicity, race, religion, region, language, or class correspond to the axes of violent conflict, a key challenge in statebuilding and peacebuilding is to ease these tensions by promoting political and economic inclusion. Such tensions figured prominently in the wars in Uganda, Guatemala, and Afghanistan but were less central in Cambodia's civil war and in the Palestine and Timor-Leste conflicts that mainly pitted the population against an external enemy.
- The *neighborhood:* The characteristics and interests of neighboring countries can have significant impacts on peacebuilding and statebuilding processes. Regional conflicts have figured dramatically in the political economy in Uganda, Timor-Leste, Afghanistan, and Palestine; they have been somewhat less central in Cambodia and Guatemala.
- The presence of an *agreement on final status:* A comprehensive peace settlement helps to remove key political issues from further contention. Where fundamental final-status questions have not been resolved, as in Palestine and Kosovo, or where some parties were excluded from the settlement and armed conflict continues, as in Afghanistan, the line between conflict resolution and postconflict peacebuilding is blurred and the political foundations for statebuilding are less firm.

- The *history of relations with aid donors:* Where international aid agencies have a long history of engagement, their past alliances with individuals and parties within the country can be both an asset to build upon and a constraint on their room to maneuver. In countries where the aid agencies have not been active in recent years, they face the challenge of forging new alliances.

Of course, no set of case studies can hope to capture the full diversity of postwar environments.[2] In choosing the ones for this volume, we have been guided by two objectives. First, we aimed for a set of countries that vary along the dimensions sketched above. Second, recognizing that different issues come to the fore over time, we selected cases that vary in the length of time that has elapsed since the beginning of postwar assistance: more than a decade in Uganda and Cambodia; medium-term experiences in Guatemala and Timor-Leste; and recent cases (where violent conflict has yet to reach a definitive end) in Afghanistan and Palestine. We also enlisted authors with a variety of professional experiences: expatriates as well as nationals of the countries whose experiences they recount; political scientists as well as economists; university-based scholars as well as individuals who work for national and international agencies.

Table 1.1 presents basic comparative data that illustrate some of the similarities and differences among our case study countries. GDP per capita, for example, varies by an order of magnitude between Afghanistan and Guatemala. The human development index (HDI), a broader measure of economic well-being that is based on education and life expectancy as well as income, is lowest in Afghanistan and highest in Palestine. The ratio of government revenue to GDP—a measure of what sometimes is called the "degree of the state"[3]—ranges from 4.5 percent in Afghanistan to 18 percent in Timor-Leste and Palestine. Public perceptions of "voice and accountability" and of government effectiveness (based on survey data on a 0–100 scale) are lowest in Afghanistan and highest in Timor-Leste in the case of voice and accountability and in Uganda in the case of government effectiveness.

As further indicators of initial conditions, Table 1.2 presents comparative data on foreign aid and inflation in the immediate postwar years. Aid ranges from 1.4 percent of national income in postwar Guatemala to almost 60 percent in Timor-Leste. Inflation rates show great variation, too, from 7 percent in Guatemala to nearly 100 percent in Cambodia.

A comparison of the revenue figures in Table 1.1 to the aid figures in Table 1.2 provides an indication of what may be termed the "degree of sovereignty" of the postwar governments: where the ratio of domestic revenue to external assistance is high, as in Guatemala, the country can be said to possess a high degree of sovereignty; a low ratio, as in Afghanistan, suggests a lower

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Table 1.1 Recent Indicators for Six Countries

	GDP/Capita 2004 (US$)	HDI 2003	Revenue/ GDP 2004 (%)	Perceptions of Governance (0–100) 2004: Voice and Accountability[a]	Perceptions of Governance (0–100) 2004: Government Effectiveness[b]
Afghanistan	228	0.346[c]	4.5	11.2	9.1
Cambodia	346	0.571	11	24.8	18.8
Guatemala	1,941	0.663	10	36.4	18.8
Timor-Leste	369	0.513	18	52.9	10.1
Uganda	263	0.508	12	30.6	38.5
West Bank/Gaza	1,110[d]	0.729	18	12.1	12.5

Sources: GDP/capita: International Monetary Fund, *World Economic Outlook Database*, September 2005 (available at http://www.imf.org/external/pubs/ft/weo/2005/02/data/index/htm). West Bank/Gaza figure is from World Bank, *World Development Indicators 2005*, Table 1.1 (available at http://devdata.worldbank.org/wdi2005/Section1.htm). Human Development Index: United Nations Development Programme, *Human Development Report 2005* (New York: Oxford University Press, 2004). Afghanistan figure is from *Afghanistan: National Human Development Report 2004* (Kabul: United Nations Development Programme, 2005). Revenue/GDP: International Monetary Fund Country Reports (Afghanistan, Cambodia, Timor-Leste, West Bank and Gaza), the Economist Intelligence Unit and World Development Indicators (Guatemala, Uganda). Perceptions of Governance: D. Kaufmann, A. Kraay, and M. Mastruzzi, *Governance Matters IV: Governance Indicators for 1996–2004*, 2005 (available at http://www.worldbank.org/wbi/governance/pdf/GovMatters_IV_main.pdf).

Notes: a. Voice and accountability measures civil liberties, political and human rights, and the extent to which citizens of a country are able to participate in the selection of governments.

b. Government effectiveness measures perceptions of variables such as the quality of public service provision, the competence of civil servants, their independence from political pressures, and the credibility of the government's commitment to policies.

c. Afghanistan figure for HDI is for 2002.

d. West Bank/Gaza figure for GDP/Capita is for 2003.

Table 1.2 Postwar Aid and Inflation in Six Countries

	Aid[a] (% national income)	Inflation (% per year)
Afghanistan (2001–2003)	19.6[b]	14.4
Cambodia (1992–1994)	11.7	98.5
Timor-Leste (1999–2001)	58.9	47.7
Guatemala (1997–1999)	1.4	7.1
Uganda (1988–1990)	9.5	29.1
West Bank/Gaza (1994–2003)	18.1	11.9

Sources: Aid: From Organization for Economic Cooperation and Development, Development Assistance Committee, International Development Statistics Online (available at http://www.oecd.org/dataoecd/50/17/5037721.htm). Refers to total disbursements of official development assistance (in 2003 US$ million). Inflation: Economist Intelligence Unit Country Reports.

Notes: a. The Aid figures refer to total disbursements of official development assistance (in 2003 US$ million).

b. Afghanistan's gross national income (GNI) figure is estimated based on the United Nations Children's Fund's 2003 GNI per capita estimate of $250 and population of 28.7 million. An alternative estimate in the World Bank's World Development Indicators dataset puts the aid/GDP ratio at 33 percent.

degree of sovereignty. Among other things, this can have implications for the international community's ability to influence the outcome of peacebuilding efforts.

Key Issues in Postwar Public Finance

Weak state capacities are a common feature of many countries emerging from violent conflict. The size of public revenue and expenditure relative to national income reflects the quantity, if not the quality, of state capacity. By this measure, some postwar governments start from near zero—as in Timor-Leste and Afghanistan—although never from a "blank slate" in terms of institutional legacies, as the case studies in this volume emphasize. Many others start from a very modest base. Today Cambodia, Timor-Leste, and Afghanistan have the lowest revenue-to-GDP ratios in Asia; Guatemala has the lowest ratio among the Spanish-speaking countries of Latin America; and Haiti has the lowest in the Western Hemisphere.

The capacity to mobilize, allocate, and spend domestic resources is crucial for the success of peacebuilding efforts for three reasons. First, governments must be able to ensure *sustainable funding* for new democratic institutions and social programs that ease tensions and redress grievances. In the early postwar years, countries often receive a substantial influx of external assistance that can temporarily address some of these needs. But aid usually diminishes over time, and so domestic resources are necessary to sustain institutions and programs. A key issue explored in this book is how external resources can be used to "crowd in" domestic resources and capacities—as opposed to crowding them out.

Second, fiscal capacities are needed in order to build a *legitimate state*. Democratic elections do not, in and of themselves, ensure state legitimacy. Neither do "quick impact projects" in which international agencies address needs unmet by the state. Legitimacy comes from government delivery of services that people need and want. This is a question not only of supply but also of effective demand, that is, state responsiveness to the citizenry. Elections are a way to express demand and to make the government accountable for its performance. There is a two-way relationship between the revenue and expenditure sides of fiscal capacity: governments need revenue in order to provide services, but they must provide services in order for people to be willing to pay taxes.

Third, in some cases there is a need to curtail extralegal taxation by warlords and armed groups, so as to *enhance security*. This has been a key challenge in Afghanistan, for example, where control of border customs outposts quickly emerged as both a fiscal issue and a security issue. It has also been important in Cambodia, where control over revenues from natural resource extraction, particularly logging, often has bypassed the state.

The case studies in this book vividly show that building the fiscal basis for an effective state and a durable peace is not just a matter of economics. It is also a matter of politics. It is a question not only of *what* should be the tax structure, expenditure priorities, and so on, but also a question of *how* these decisions should be made. For war-to-peace transitions and the democratic transitions that are often part and parcel of the peace settlement, the process of public finance decisionmaking—including issues of transparency, accountability, and participation—can be as crucial as the policies themselves.

Revenue Mobilization

On the revenue side of fiscal policy, the conventional criterion for assessing the "soundness" of public finance is efficiency. Taxation and nontax revenue collection (such as fees or earnings from state-owned enterprises) should be efficient both from an administrative standpoint, taking into account administrative costs, and from the standpoint of minimizing distortions in economic activity. The latter, for example, is the main rationale for the shift from tariffs to value-added taxes that has been a centerpiece of policy advice from the international financial institutions in recent years.

In war-torn societies, "soundness" must be reassessed in light of the goals of conflict prevention, conflict resolution, and postconflict peacebuilding. Given the enormous human, social, and economic costs imposed by violent conflict, these goals can be understood as part of a broader, more robust notion of efficiency, rather than as a departure from the efficiency objective. The studies in this book shed light on what it would mean to translate this broader notion of efficiency into practice in the field.

As we have noted, in postwar settings efforts typically must be undertaken to increase the size of revenue. There is room for debate as to what is the "efficient" size of the state relative to the economy, as measured by the revenue/GDP ratio. In the United States, the ratio currently is 33 percent; in the euro area, the average ratio is 45 percent; among the member countries of the Organization for Economic Cooperation and Development (OECD), it ranges from 31 percent in Korea to 60 percent in Norway.[4] Whatever one's opinions as to how high a ratio is "too high," there can be no doubt that the ratios in postwar countries are often too low. Indeed, the British government's Department for International Development regards a tax/GDP ratio of less than 15 percent to be an indicator of "state fragility."[5]

Where the need for additional revenue is great and administrative capacities are low, types of taxes that might be considered "distortionary" in other settings may well turn out to be the most efficient available options. Notwithstanding the conventional case for trade liberalization on efficiency grounds, for example, trade taxes that can be collected at a relatively small number of border crossing points are attractive from an administrative standpoint.

Looking at revenue policies through the conflict lens also brings out the need for serious attention to distributional impacts on both "vertical" and "horizontal" equity. Vertical equity—the dimension most familiar to economists—refers to distributional impacts across the population stratified from rich to poor: taxes that fall more heavily on the rich than on the poor (as a percentage of their incomes) are termed "progressive," whereas those that fall more heavily on the poor are termed "regressive." Horizontal equity refers to distributional impacts across regions or population subgroups defined in terms of ethnicity, race, religion, caste, or language—divisions that can correspond to the social fault lines of conflict.

It is sometimes argued—mostly by economists with graduate-level training in public finance—that distributional issues ought to be addressed exclusively on the expenditure side of fiscal policy, leaving revenue policies to be set so as to maximize efficiency and minimize distortions. Three points can be made in rebuttal to this argument.

First, this stance rests on an "optimal planner" model that assumes that the government aims to achieve a target that defines the optimal income distribution after taxes and transfers. This assumes, in turn, that the government is both omniscient and omnipotent; that is, the government knows the distributional effects of everything it does, and indeed of all else that is happening in the economy, and it has the power to hit the target, subject only to random differences between actual and expected outcomes. But such optimal planners exist nowhere except in the writings of public finance theorists. It would be fanciful to imagine that they inhabit postwar governments.

Second, even if policymakers choose to pursue distributional objectives mainly via the expenditure side of fiscal policy, they need to take into account the distributional impacts of revenue collection in setting these objectives. In other words, the conventional textbook wisdom does not logically imply that the distributional incidence of revenue policies can or should be ignored. On the contrary, this is essential information for policymaking.

Finally, no matter what public finance theorists believe, most members of the public simply will not accept the claim that the distributional impacts of taxation and other revenue policies "do not matter" because everything is being optimally adjusted on the expenditure side. This is true even in high-income, industrialized societies, where tax reform proposals routinely are subjected to exhaustive scrutiny on distributional grounds. It is even truer in war-torn societies where mistrust of the government generally is more widespread. Regardless of what economic theory tells us, political theory tells us that if enough people think something matters, it does.

In recent years, growing recognition of the interplay between economic policies and conflict dynamics has prompted efforts to introduce "conflict impact assessment" into decisionmaking at official development assistance agencies. Much as environmental impact assessments are intended to take into account "negative externalities" in the form of pollution and natural resource depletion, conflict impact assessment aims to incorporate impacts on social tensions and risks of violent conflict into policy formulation and project appraisal. As on the environmental front, it will take serious commitments of time and effort to develop capacities to conduct such assessments and integrate them into decisionmaking processes. As of this writing, the application of conflict impact assessment to revenue policies is still in its infancy.

Budget Allocation and Expenditure Management

On the expenditure side, as on the revenue side, the "soundness" of public finance is often defined in terms of efficiency, tempered perhaps by concerns for "optimal distribution." Budget allocation and expenditure management, in this view, should aim to maximize social returns, so as to get the most "bang for the buck." Once again, in war-torn societies the soundness of expenditure policies can be judged only by a broader standard of efficiency that encompasses conflict dynamics. In effect, expenditure policies must also be devised with an eye on getting the most "nonbang" for the buck.

In all societies, government expenditures are needed to provide public goods and services, things that cannot be efficiently produced and distributed by private-sector markets. These include not only physical infrastructure, such as roads and electricity grids, but also the institutional infrastructure for providing education, health care, public safety, and the rule of law. War-torn societies are likely to face large shortfalls in these types of infrastructure. They also often need substantial investments in what can be called the *social infrastructure of peace:* expenditures that redress the horizontal and vertical inequalities that are implicated in violent conflict. In addition to measures to redress historic disparities, such investment could encompass assistance to demobilized ex-combatants and to the communities that will support their reintegration into civilian life.

The expenditure side of public finance has two distinct stages. The first is the framing of the budget, allocating scarce public resources among competing uses, in the course of which expenditure priorities are determined. The second is expenditure management, implementing the decisions taken in framing the budget. At both stages, policymakers must face issues of participation, transparency, and accountability as well as efficiency. Answers to the process question of *how,* as well as the outcome question of *what,* can strongly affect public attitudes toward the state and the depth and breadth of public support for peace. They also have a strong effect on the willingness of the public to pay taxes: revenue is needed to fund expenditure, but at the same time effective expenditure that responds to the needs of the people legitimizes revenue collection.

A key problem in public expenditure—one that may be particularly acute in war-torn societies—is the set of phenomena that are commonly lumped together under the label "corruption." A distinction is sometimes drawn between "grand corruption," in which policy decisions (such as budget allocation) are manipulated to benefit powerful interests at the expense of the public interest, and "petty corruption," which involves the payment of bribes for government services or kickbacks on government contracts. Both kinds of corruption can squander scarce resources, undermine state legitimacy, exacerbate inequality, and deter private investment.

There is a gray line between corruption driven by personal greed and corruption driven by the desire to sustain political alliances and lubricate political networks. The latter—sometimes referred to as "patronage," a term with somewhat less negative connotations—can have similar corrosive effects on economic performance and state legitimacy, but against the costs must be weighed the benefits of the political cohesion that patronage can buy. And the latter may be more important in war-torn countries than in settings where political contests are resolved peacefully. Here the challenge is not only to strike a balance between the costs and benefits but also to devise strategies that ease the trade-offs posed by patronage-based political systems. Accommodating patronage in the name of short-term political stability—as happened in the Palestinian Authority during the Arafat era—not only stunts the effectiveness and legitimacy of state institutions but also turns out to be a less-than-sure recipe for building a durable peace.

External Assistance and Fiscal Capacity: "Crowding In" or "Crowding Out"?

In the wake of violent conflict, countries often receive an "aid bonanza." The influx of humanitarian assistance, reconstruction aid, and international support for peace implementation brings large-scale external resources into the country, at times dwarfing the domestic resources mobilized by the government.

Although postwar aid can play a valuable role in meeting pressing needs, it poses the risk of crowding out local efforts to lay the fiscal foundations for an effective and legitimate state. The ready availability of external resources can reduce the incentive for the government to raise domestic revenues: it is easier to rely on foreign aid than to collect taxes. On the expenditure side, the influx of aid can overwhelm the state's limited capacity to disburse funds in a timely and transparent fashion. But if much of the aid is routed through private contractors and nongovernmental organizations, bypassing the state, this can undermine efforts to build state capacities in budget allocation and expenditure management.

The potentially adverse impact of external assistance on domestic fiscal capacity is one dimension of a broader dilemma that confronts international efforts to promote statebuilding. Just as external resources can crowd out domestic resources, so the government's quest for external legitimacy can under-

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