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Citizen-Centered Approaches
to State and Market

Peacebuilding and Public Finance

BUILDING STATES TO BUILD PEACE CHAPTER 4

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A sustainable system of public finance is foundational to the building and ongoing operation of a stable state. The state's capacity to collect and expend revenues underpins its ability to deliver basic services to its citizens, including security, social services, and infrastructure. The ability of the state to collect revenues depends on whether its citizens perceive it to be legitimate; the state will be increasingly seen as legitimate if it can allocate resources and manage expenditures effectively and equitably. Rebuilding the public finance system can, therefore, both underpin and reinforce a virtuous cycle as part of broader efforts to build a legitimate and effective state. However, external aid that bypasses the public finance system can undermine efforts to build state capacity, turning a potentially virtuous cycle into a vicious one.[1]

In this chapter we examine the centrality of public finance to building a functioning state. The first section outlines why an effective public finance system is integral to statebuilding, and the second section analyzes what a functioning system of public finance entails. Those sections provide the context for a two-part discussion of how interventions led by the international community undermine statebuilding efforts by channeling funds outside the government and relying on parallel mechanisms of their own creation. The final section proposes some ways forward that offer an alternative approach that places the public finance system at the center of international statebuilding interventions.

Why Focus on Public Finance?

A functioning public finance system is the backbone of an effective and legitimate state. A public finance system is integral to statebuilding because it underpins the ability of the state to perform its core functions, which necessarily supports efforts to build state capacity across other domains.[2] By building up the public finance system in a postconflict country, the capability for strategic planning can be developed through the budget process, which should be the locus for formulating, coordinating, and monitoring policy. A holistic approach to developing the public finance system, with a particular focus on balance between revenue and expenditure, is essential to ensuring the public finance system can meet its potential as the foundation for an effective state.

The key to success in restoring state functions is well-sequenced and coherent progress across economic, political, security, and administrative domains. Progress—or failure—across these domains tends to be mutually reinforcing. Improvements in the security situation are reinforced by a functioning, representative, and inclusive political system. Economic growth will only occur if security is improving and the political situation becomes more stable, but increased economic growth is itself the foundation upon which a sustainable politics and security can be built over the longer term. Forward movement on all these fronts generates a mutually reinforcing process that can contribute to the creation of a stable and prosperous society.[3]

Building a sustainable public finance system is a fundamental part of this mutually reinforcing process. Domestic revenue must be collected and spent in priority areas, including the investments in human, physical, and institutional capital that lay the foundations for economic growth. When the government is seen to be delivering services and reporting transparently on revenue and expenditure, its legitimacy is further enhanced. In a postconflict situation, where trust between groups is low, a mechanism that ensures the transparent and even-handed allocation of resources can be especially important. When the government allocates resources in a transparent and accountable way, the influence of spoilers and competing actors can be undermined.

In the absence of a strong public finance system, a vicious cycle can fast be reinforced. Revenues will be inadequate to meet expenditure needs, and the revenues that are collected are likely to be misallocated or stolen and may be used to fund illicit activities that generate instability. Unlike domestic revenue collection, which often spurs calls for accountability in government expenditure, citizens have little stake in the efficacy of foreign aid expenditure, reinforcing a culture of lack of accountability. Alternative sites of authority emerge and are reinforced, and the authority of the state is weakened.

Developed countries have traditionally engaged with fragile, failing, or failed states by compartmentalizing issues into clearly defined silos. The United Nations typically takes the lead in political reform, including designing and implementing peace processes. This political process is supported by security arrangements, usually provided by combinations of forces sponsored by varying groups, including the North Atlantic Treaty Organization (NATO) and the Organization for Security and Cooperation in Europe

(OSCE). Responsibility for ongoing law and order has had a range of champions. Economic reform has been the responsibility of the International Monetary Fund (IMF), the World Bank, and regional development banks. UN agencies and nongovernmental organization (NGOs) have tended to focus on the delivery of social services.[4]

Interventions are further complicated because multilateral actors are joined in any exercise by a number of bilateral partners. In most cases each individual donor country is represented by a different agency within its government: the political domain may be covered by a foreign ministry, the security domain by a defense ministry, the economic domain by a finance ministry, and the social domain by a development ministry, with no guarantee that representatives from each ministry will agree on the way forward.

There have been calls for both domestic and international actors to employ a more strategic approach to planning, underpinned by core statebuilding imperatives, in a postconflict period.[5] The budget is the instrument most likely to ensure that any such strategy gets traction in practice. The budget is the mechanism binding the state to transparency and accountability in the use of finances: through the transparent preparation of a budget and tracking of its implementation, actors can most effectively be held accountable for playing by new rules of the game.

In Afghanistan, extensive studies undertaken by NATO strategic planners during 2004 demonstrated that the creation of a public finance system and credible institutions were fundamental to the creation of a secure environment over the medium to long term. Supported by a team of strategic planners and international experts, the government of Afghanistan led the preparation of a twelve-year statebuilding plan and programs to which resources would be pledged.[6] The budget underpinned this plan, which itself focused on reinforcing the ability of the state to collect revenues and plan effective expenditures.

In political or security discussions ambiguity can often be a useful way to garner an initial consensus, enabling incremental progress over time.[7] In contrast, questions of public finance, such as the rate of customs duty to be levied on goods or the amount of money that would be spent in a given year on the defense force, require early precision. Early in the life of a new government, budgets are prepared, revenues collected, and expenditures made. The allocation of scarce resources is among the first concrete decisions that a new administration must take. The exercise of preparing and agreeing on a budget can be an important tool in consensus building and capacity building for cabinet governance. In this way, the public finance system generally, and the budget more specifically, provide a tangible discourse that drives change in the sphere of political decisionmaking. The budget process should accordingly become the locus for the formulation, coordination, and monitoring of policy, and a critical tool of strategic planning in any statebuilding effort.[8]

Within the public finance sphere, balanced progress must occur across different domains. A strong budget that precisely allocates spending to high-priority areas is worthless if there are no staff in ministries who can effectively run these programs. Indeed, without the capacity to spend effectively, domestic revenue collection may undermine the statebuilding agenda as patronage and corruption become institutionalized. Balanced support is required between the revenue and expenditure sides of the public finance system. For example, Kosovo faces particular challenges because the revenue system was built up rapidly and effectively, but the expenditure side received less attention. Consequently, Kosovo collected revenues of around 30 percent of gross domestic product (GDP); a figure of around 15 percent is considered by the international financial institutions (IFIs) to represent a strong revenue effort in a postconflict context. Considerable public sector hiring took place, and several programs commenced without careful planning. Now, Kosovo faces difficult decisions on what areas to cut back as revenues are not growing fast enough to match the growth in expenditures.

In concluding this section, it might be helpful to consider two different views of statebuilding. One view posits that political legitimacy can be created and shored up through the use of patronage to support specific groups. In a postconflict situation, there is a risk that this approach leads to the consolidation of a criminal-mafia regime, because the groups that most need to be appeased are often those that thrived during war and became connected to international money laundering, weapons supply, and other illegitimate global interests. Another view posits that unless a rules-based system is instituted as soon as possible, based on the realization of citizens' rights and duties through transparent, accountable rules and systems, these criminal networks and their interests will capture the state. A functioning public finance system is the key catalyst to the latter process.[9]

What Constitutes a Functioning and Sustainable System of Public Finance?

Public finance involves estimating available resources, allocating resources to priority needs through a budget, collecting revenue, expending resources against the budget, and monitoring and reporting on these collections and expenditures.[10] The key to building a sustainable public finance system is to design a system that is clearly rules-based, with very little room for individual discretion. The system should provide predictable and transparent management, requirements for regular reporting to the public and the legislature, and limits on opacity. These features must be developed across the entire public finance system, including the domains of revenue, expenditure, and public debt. This section offers a brief overview of each of these domains.

Revenue

The government must have the capacity to estimate the amount of revenue that will be collected under existing legislation, enact legislative changes if revenue needs to be increased or decreased, and then administer the system to ensure that the revenue is collected. Estimating the available revenue involves analyzing data from previous years, estimating the changes in major macroeconomic parameters (such as GDP and inflation), and then estimating the impact of these changes on likely revenue collections.

The two key aspects of revenue administration are tax and customs. There are four key elements in taxation administration: registering and accounting for payments from taxpayers; assessing and reconciling the amounts paid by taxpayers with overall obligations each year; educating taxpayers; and enforcing the tax laws, which generally involves a focus on large taxpayers, an active program of audits, and court-based prosecutions. Customs administration involves the collection of all relevant duties and levies, including customs and excise duties. This work includes valuation of goods, determination of eligibility for exemption, export/import procedures, controls of import quotas, and physical examination of goods.

A cursory consideration of these aspects of revenue administration shows the intimate link between public finance and the other domains of statebuilding. Without a functioning security sector, the enforcement and compliance needed to operate a revenue system will be inadequate. In the absence of broad political support for the administration and an acceptance of its legitimacy, there will be such a high volume of willful noncompliance that only an extremely draconian enforcement effort will yield any revenue (and will itself further undermine the government's legitimacy).

There are two major challenges to building a sustainable revenue system. First, there must be adequate economic activity from which revenue can be extracted. In the absence of productive activity, there is nothing to tax, and there will be no revenue. Therefore, economic growth and sound macroeconomic and microeconomic policies are critical. Second, the tax and customs administrations require a strong cadre of public officials who are well trained, adequately remunerated, and committed to building a strong revenue service.

In postconflict economies there is often no shortage of international assistance to develop physical and technological infrastructure.[11] However, there is usually a shortage of experienced and well-trained revenue officials. This constraint dictates the way in which the revenue collection capacity in postconflict countries is likely to develop.

Most postconflict countries have tended to follow a four-stage sequence, driven by the initial shortage of trained revenue officials. There is usually an initial focus on customs collection, particularly where there are a limited number of border points that can be policed with a relatively small staff. The next development is usually the introduction of a services tax, generally on services consumed by the expatriate community, such as hotels, restaurants, and telecoms. The third development is the creation of a large taxpayer unit, focusing generally on the 100 to 500 largest taxpayers, as they provide the bulk of the corporate income tax revenue. The fourth development is personal income taxation, often with pressure to introduce a comprehensive personal taxation system in advance of the first major civil service pay raise under the new administration. Subsequent developments will depend on the individual country's circumstances and can include resource taxation or more comprehensive indirect taxation.

Expenditure

A functioning public finance system uses the available revenue to provide services to individuals and communities, including social services, safety and security of person and property (including police and a justice system), and access to essential physical infrastructure services. There are three distinct phases in an expenditure system: budget preparation, budget execution, and monitoring and auditing expenditure. The first component in public expenditure management is the preparation of the expenditure plan. Preparing a budget involves bringing together all spending proposals, evaluating them for their cost-effectiveness, and presenting them in a complete and coherent form so that decisions on priorities can be taken by the relevant political decisionmaking body—usually a cabinet or a group of senior ministers working with the president or prime minister. This is generally coordinated by a ministry of finance, in close consultation with other ministries. Then, depending on the structure of the legislature and the relationship between the legislature and the executive branches of government, there may be additional modification of the spending plan.

The international development community lacks a well-developed understanding of the need for a unified expenditure plan in the form of a budget. Rather, the majority of international actors often seem to resent a budgeting process that limits their freedom to do what they want with their aid money. Each international partner allocates expenditure in its own interest, or in its perception of the national interest of the recipient country, inevitably leading to a whole that is less than the sum of its parts. A comprehensive and coherent budgeting process is vital to ensuring that overall expenditure meets the national interests, rather than a collection of sectional interests.

Governments use budgets to prepare expenditure not because some things are unimportant, but because everything is important. Budgets allow prioritization among competing goods: they allow questions to be asked and choices to be made about what is more important and what is most important. The relevant question is not whether reducing maternal mortality or improving farm access to markets is important. Rather, in a world where resources are limited, the question is what level of resources should be allocated to each activity. Preparing expenditures in a piecemeal fashion, in which each organization has its plan, does not allow for this overall perspective and prioritization, nor does it allow for easy coordination. Planning expenditure through a budget process ensures that trade-offs can be made and balance maintained across dimensions. Balance must be maintained between sectors, between capital and operational expenditures, between staffing and operational costs, and across geographically and ethnically diverse communities. The budget, in sum, is the site where trade-offs between multiple and competing aims can be analyzed and managed.

Once the budget has been legislated, the next step is to carry out the spending program in accordance with the legally approved budget, which is generally the responsibility of the treasury within the ministry of finance. It involves preparing monthly or quarterly allotments for different budgetary units of the government and processing their expense reports. When expenditures are legitimate, payments are issued to the claimants. The treasury must also manage cash flow on an ongoing basis to ensure that government finances do not go into deficit, unless there is legislated approval to borrow. Management of cash flows is complicated when there are multiple sources of funds, such as special accounts or dedicated multilateral trust funds.

Creating a single treasury account, into which all resources of the state flow and from which all payments are made, will facilitate cash-flow management. A particular challenge in many countries, including Afghanistan, has been the presence of multiple accounts, with many ministries having their own accounts. This makes it very difficult to assess the country's overall fiscal position and trade-offs between different spending priorities. Moreover, given the limited auditing and accounting capacity in Afghanistan, the presence of multiple accounts makes effective oversight and monitoring very difficult.

The final task is monitoring and reporting on expenditure, which includes the preparation of monthly, quarterly, and annual expenditure statements that report on expenditure by each ministry against its budget allocation. Trained staff can use these expenditure reports as the basis for assessing the effectiveness of expenditure. The expenditure report indicates how much money was spent on a particular project, but additional analysis is needed to determine whether the expenditure actually delivered the benefits or provided the services that it was designed to. Additionally, targeted auditing programs are needed to ensure that public funds are spent in accordance with the budget and the law.

Regular reporting on revenue and expenditure to the organs of government and to the public fosters transparency and accountability in governance. Regular and timely reports on primary expenditures must be institutionalized.

In Afghanistan, monthly reports are submitted to the cabinet on revenues and expenditure, and regular reports from international auditors are submitted to cabinet-rank ministries on the proportion of their expenditure that was ineligible according to the laws of the country. The degree to which ineligible expenditures occurred and the extent to which abuses were addressed led to reductions in future funding allocations to that organ of government. Pending the creation of parliamentary oversight mechanisms, regular reports were made to the nation through press conferences and at the *loya jirgas* to summarize the same issues.

Public Debt

The goals of debt management policy include managing the net debt portfolio of the country at the lowest cost over the medium term and supporting market efficiency through borrowing operations in the financial markets. The government needs the capacity to issue a range of debt instruments of varying maturities to ensure that it can access sufficient funds to continue operations.

Countries that have experienced regime change often face the issue of liabilities incurred by previous regimes. There may be questions about whether the previous regime was legitimate, or cases in which borrowed resources were squandered. If a previous regime received military hardware and training on credit that were later used to oppress the population, should that population have to pay for the bullets that killed their families after the regime is ousted?[12] The prevailing position has been that the new regime inherits the liabilities of the old regime. This approach protects the fiscal rights of citizens in lending countries at the expense of citizens in borrowing countries.

The period after regime change or conflict poses a range of challenges to the indebted country. A new beginning provides an opportunity for major debt write-offs and the possibility of obtaining donor support to fund any arrears in repayments—a prerequisite for obtaining new multilateral funding. Although there may be external pressure for the new government to enter into a Paris Club process to have the debts consolidated and repaid at a highly concessional rate, this decision should be made with care. To enter into such an arrangement requires the new country to acknowledge that the debts are legitimate, when they may not be.

Other Economic and Financial Functions of the State

The focus of this chapter is the relationship between building the institutions of public finance and statebuilding. There are also a range of economic and financial state functions outside the domain of public finance per se that should be considered in any discussion of statebuilding. When carried out effectively, these functions support a growing and dynamic economy. Several of these functions are briefly summarized below, although to fully capture each of these issues is beyond the scope of this chapter.

Monetary affairs. The institutional arrangements around the monetary authority need to be well designed, including its degree of independence from the rest of the government and its associated reporting responsibility and accountabilities. There will be other challenges in a postconflict environment: ensuring that the financial architecture is operating, setting the overall goals of monetary policy, and making the instruments available to the monetary authority to conduct that policy and potentially the choice of currency.

Management of state assets. The management of the tangible and intangible assets of the state is a second key area requiring attention in the immediate aftermath of war. It is ironic that, as donors pledge billions of dollars to postconflict countries, billions of dollars in state assets can be transferred into private hands, entrenching and empowering a criminalized elite. Tangible assets can be transferred through the granting of rights over assets, including rights over forests, oil, gas and minerals, antiquities and cultural heritage, land, and fishing. Public assets can also be transferred into private hands through the granting of monopoly rights over key sectors. Sadly, monopolies of this kind can destroy value by entrenching inefficient and costly market structures. Poor management of state assets in this way entrenches a winner-take-all mentality, with public assets treated as spoils to be divided. Such an approach is opposed to a more cooperative growth-based model for development and is likely to undermine stability and contribute to ongoing conflict.[13]

Transforming the illegal economy. In developed countries, the market and economic institutions can be assumed to exist. Often the task becomes one of ensuring the right balance between free market activity and government direction or regulation. In developing countries, and, more specifically, in postconflict countries, the market and economy do not exist as functioning institutions. During the conflict, networks of criminality are likely to have flourished and thus, the networks of an *illegal* economy have become entrenched and institutionalized. The creation of a legitimate economy as an institution is an essential task for economic policymakers in a postconflict situation. It is clear that the international community has not yet identified the mechanisms to do this. The current mechanisms—including drafting legislation and establishing anticorruption units—may be insufficient. If the challenge is to create a legitimate capitalist class who will be both willing and able to pay taxes—and will demand a functioning state—other mechanisms need to be identified.[14]

The Impact of Development Resources on State Capacity

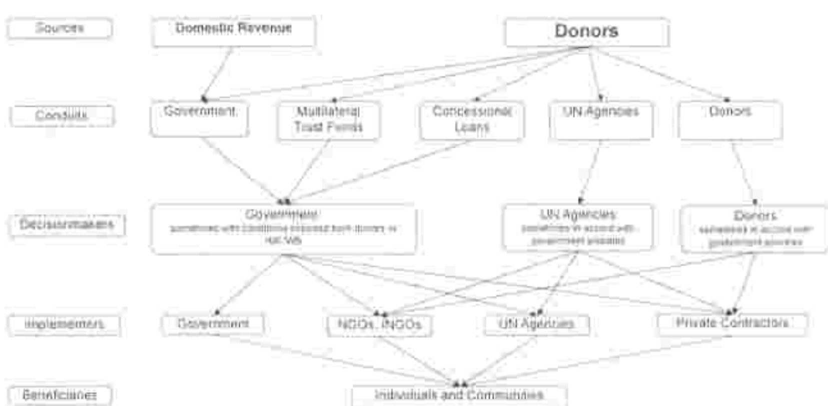
To understand how the international assistance community can support or undermine the creation of a sustainable public finance system, it is important to understand how funds flow and how decisions are made in the current system. Funding for development assistance starts as domestic revenue collected by donor countries and is designed to provide assistance, either directly or indirectly, to developing countries. The channels through which the funds flow, and the modalities through which they are spent, will determine how much money trickles down to the beneficiaries and how much is diverted to meet other objectives. These decisions will also determine whether the international development industry supports or undermines the building of state capacity. Fieldwork across six countries, reviewed by leaders of postconflict transitions at a conference at Greentree Estates in September 2005, found that the majority of current international practice undermines the statebuilding agenda.[15]

How Resources Can Flow: The Architecture

The prevailing understanding of the flow of funds in the international development system is illustrated in Figure 4.1 below. It delineates five elements in the process: the original funding sources, the conduits through which the funds pass, the decisionmakers, the implementers, and the beneficiaries.

The main *sources* of development funding are the private citizens and companies in donor countries. Some funds are collected in the recipient country through taxation of domestic economic activity, license fees, or the sale of state assets. However, the bulk of public spending in postconflict countries comes from revenue collected in donor countries and then allocated by the donor government to the recipient country. In some cases, international

Figure 4.1 The Flow of Resources in Developing Countries



nongovernmental organizations (INGOs) collect funds directly via donations, but the majority of their funds come from donor governments.

Funding conduits are the channels through which funds flow on the way to their final destination. Domestic revenue is channeled directly to the government. Donor funds can pass through several possible channels. Some funds are provided directly to the host government from the donor in the form of tied or untied budget support. In the case of untied budget support, the donor simply deposits the money in the government account, and for all intents and purposes it can be treated like domestic revenue. Otherwise, the donor may direct funds toward a specific portion of the budget (e.g., earmarking it to pay teachers' salaries). In some cases, donors may wish to provide direct support to the operations of the government but may use a multilateral channel. Multilateral trust funds have been established for many countries to provide budgetary support, often with conditions attached (e.g., funds could not be used to purchase lethal weapons).

Some donor funds are used to support the operations of development banks and other international financial institutions, including concessional lending operations. Donors also provide funds to development banks, either directly or by funding endowments that the development banks then provide as grants. In some cases, donor governments provide money directly to United Nations agencies or NGOs. That is, a donor government will agree to fund a project that has been designed by a United Nations agency. Finally, the development agency or other agencies from the donor government may choose to retain and program the money itself.

Decisionmakers determine how and where the money will actually be spent. There are at least three possible decisionmaking loci. The first decisionmaker is the recipient government itself. Theoretically, the government has full control over how it spends its domestic revenue. In the case of budget support, the government presents a proposed expenditure plan, and if donor governments support it, they may provide resources for the plan.

A second possible decisionmaker is intergovernmental organizations, including IFIs and UN agencies. When the government borrows or receives grants from IFIs, the government is the notional decisionmaker, although the preferences of IFIs, especially where conditionality is exercised, often shape government's expenditure patterns.[16] For UN agencies, funding is often provided from donor governments against very general project proposals, with great pressure on donors to disburse. Under such a general remit, a UN agency can often determine unilaterally where it works, what type of services or benefits it provides, and who the beneficiaries of the services will be.[17]

A third possible decisionmaker is a donor government's development agency, which can allocate funds as it wishes. In some cases, donor funds are earmarked to particular sectors, but even within those sectors the development agency can decide on issues such as the location and precise nature of the projects.

Implementers are the organizations that actually produce things: delivering services, building infrastructure such as roads or schools, or digging wells. Generally, implementation is carried out by one of four groups: the government, a small number of UN agencies, NGOs, or private contractors. There are several important points to bear in mind regarding implementation. First, development agencies and UN agencies almost never actually implement programs directly; they contract other organizations (usually NGOs or private contractors) to do so. Second, the distinction between NGOs and private contractors is often blurred. Many private contractors will register as NGOs in order to receive preferential tax treatment. Third, regardless of which conduits the money goes through, donor agencies, UN agencies, and the government all end up using the same implementers. Where implementation capacity is limited, these actors compete with each other to ensure *their* projects are implemented.

The *beneficiaries* are the individuals or communities who receive the services that are delivered. That is, the beneficiaries are people who are treated at the clinics, who can travel on the improved road network, or who have better access to potable water.

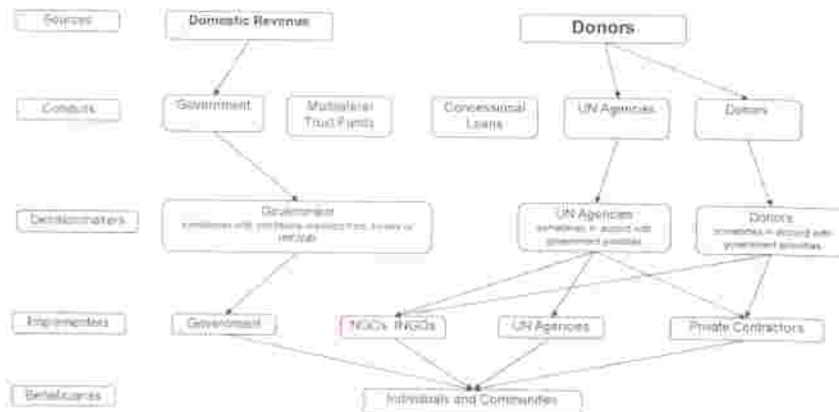
How Resources Flow in Practice

In postconflict countries the vast majority of resources flow outside government channels. Some resources flow to the government in the form of budget support or development bank credits and grants, but these funds are often eclipsed by the money that flows outside the government. In the case of Afghanistan, for instance, over 80 percent of funds bypassed the government system during the first three years. Even in the case of East Timor, where the international community initially served as the government, over 55 percent of resources were channeled outside the government, with a further 35 percent being provided through a multilateral trust fund. Figure 4.2 represents this dynamic.

In this situation, the only source of funds available to the national government is domestic revenue, apart from any funds received in the form of direct budget support or through trust funds. In a fragile state, and particularly in a postconflict situation with weak economic activity, domestic revenue is often quite low. For political and practical reasons, the highest priority for domestic revenue is generally the payment of civil service salaries. So in the absence of other resources, domestic revenue can simply become entrenched as a source of patronage with no concept of service delivery.

Typically, donor governments provide the money directly to UN agencies or program it themselves by contracting NGOs or private companies. This approach undermines the building of a sustainable state by reinforcing parallel mechanisms rather than state institutions, by spending inefficiently

Figure 4.2 Flow of Funds in Practice



due to a lack of coordination among donors, by exacerbating intergroup tensions through an inequitable distribution of assistance, and by creating expectations that cannot be sustained. Moreover, in response to the argument that operating outside the government is faster, it is not clear that bypassing the government actually allows international organizations to deliver services more quickly or more cheaply. The same contractors on the ground are used as implementers regardless of the channels through which the funds pass.

Parallel mechanisms undermine state structures and government authority. By establishing parallel decisionmaking structures, the international community undermines the creation of these structures within the state apparatus. This is particularly pertinent in the case of the cabinet or senior political decisionmaking body. A functioning cabinet is a critical ingredient for a stable state. When given the opportunity to make real decisions, over real resources, institutional capacity can be dramatically strengthened. Too often, major decisions are made without recourse to this body. Even more problematic is when donor countries take advantage of nascent decisionmaking capacity by seeking bilateral deals with elements within the government in order to claim "government" support for their priorities.

Parallel mechanisms also prevent bonds of citizenship from forming between the government and its citizens. These bonds are developed and strengthened through consultation on the use of state resources and through the ability of citizens to hold the government to account for its decisionmaking on public expenditure. If the government does not manage the funds, it cannot be held accountable.

The public expenditure system in a postconflict or fragile state often resembles a set of old pipes. There are a series of leaks in the system, but until water is flowing in the system it is not possible to identify the leaks and patch them so the funds flow effectively. By keeping funds out, the opportunity to strengthen the financial management system—including budget execution, auditing, and accounting—is lost. Critics may argue that funds will be wasted in this process, but unless the system is repaired and functioning, the state will never be able to function independently.

Parallel mechanisms undermine capacity building. Not only do parallel mechanisms undermine the exercise of government authority, but they also draw human resources out of the government and undermine attempts to build the capacity of public officials. When donors contract UN agencies or NGOs to manage projects, each of these actors must hire financial managers, accountants, administrative staff, and project managers.

Unfortunately, postconflict and fragile states often have a very limited supply of skilled labor to fill these positions. When donors or agencies offer salaries well above what the government can pay, they undermine the ability of the government to recruit skilled staff and develop the capacity to operate the public finance system. In situations in which each donor and each UN agency is operating a series of projects, these scarce human resources are dispersed across a number of small projects, rather than being in a position to manage the overall spending portfolio. Even more ironic is when international organizations fund large and expensive technical assistance projects to build government capacity. The highly paid international consultants that are flown in to manage such projects often recruit the most talented civil servants to work as their assistants, while the less talented staff remain in the government to attend the trainings. This impact is particularly pronounced when there is a large UN mission present, for example in Cambodia, Kosovo, or East Timor.[18] Although studies have not been undertaken on the effects of a large *non-UN* international presence, the results can be extrapolated from studies of UN missions because bilateral donors regularly pay even higher wages than multilateral organizations.

Uncoordinated expenditure planning leads to ineffective expenditure. Generally, the host government prepares a budget based on an estimate of the resources that donors may provide. These resources are then disbursed to the government during the course of the year, but often in an uncoordinated and unpredictable manner. There are two strongly negative consequences of this approach. First, after preparing a budget and ensuring its passage through the legislature, the Finance Ministry then must spend much of the year chasing donors for funds to ensure that the pledges of budget support are actually delivered. Second, the nebulous offer of support

that many donors make is often interpreted by less experienced ministers as meaning budget support. What this has meant in practice is that when the finance minister presents the draft budget, with difficult trade-offs, to the cabinet, other ministers suggest that, rather than prioritize within a spending envelope, the government should seek additional funds from the international community. In this way the presence of unpredictable budget support from donors undermines the development of good public finance decision-making. Similarly, there is little support for politically unpopular revenue measures when ministers see the donors as an easier source of revenue.

When expenditure takes place in this uncoordinated fashion, the benefits of budgeting will be lost. In particular, the balance between spending in different sectors; between investment, operations, and maintenance expenditure; and between popular and essential expenditure will no longer be maintained.

This approach undermines the building of a sustainable state in at least two distinct ways. First, effective public spending is a critical component of creating an environment for strong economic and employment growth. It can play a key role in creating a virtuous cycle where stronger economic activity and employment growth helps create stakeholders in a stable society, drawing people from illicit or destabilizing activities into productive employment. Stronger economic performance also supports the collection of the domestic revenue needed to fund an adequately remunerated security force.

Second, despite the fact that the funds are not channeled through the government, the citizens in the recipient country are aware of the pledges of assistance from the international community. They may then apportion some blame to their government for the way in which these funds are spent. When the funds are spent in a haphazard manner and services are not delivered effectively, the legitimacy of the government and the trust that the people place in it will be harmed.

Geographic and ethnic inequity in spending compromises political and security developments. Lack of coordination leads to spending and service delivery that takes places in a geographically and ethnically unbalanced manner. International organizations prefer to deliver their programs in areas of the country that are close to major population centers in order to reduce costs and speed up the delivery. They also want to work in the safest areas of the country. In the absence of coordinated nationwide programs, the benefits of the influx of foreign funds will only be felt in selected areas. This disparity is likely to fuel existing political and security tensions and inhibit progress in bridging these critical divides and is particularly problematic where there are ethnic and geographic disparities in access to the benefits of foreign funds. These situations are likely to engender a vicious cycle in which the initial disparity of resources fuels additional political and security tensions, further reducing the likelihood that donor programs will operate in these areas.

Short-term delivery of services by external actors may create expectations that cannot be sustained. Delivery of expensive services may create expectations that cannot be sustained. For example, the creation of externally funded new armed forces may not be fiscally sustainable. In addition to creating unrealistic expectations, services may erode traditional coping mechanisms, leaving communities in a worse position than before. For example, the United States Agency for International Development (USAID) undertook a major health program in Afghanistan, funding clinics to deliver basic health services. These clinics operated at a significantly higher cost than other clinics: the unit cost was estimated to be more than double the cost for service provision under a World Bank grant to the government. Unless donors fund these clinics in perpetuity, the service level will be reduced when operation of these clinics reverts to the government.

Does this approach deliver better results? International actors generally choose to use channels outside the government because they are trying to avoid corruption or to allow more rapid implementation. In rare cases, channels outside the government are needed because the government actually opposes the program (e.g., girls' education and some women's health services under the Taliban) or because the project is designed to support civil society or the media to increase government accountability.

One particular irony in the development industry is that, regardless of the way the funds flow, it is the same group of implementers (either NGOs or private contractors) that do the work. The difference is whether they are contracted by the government, by a UN agency, or directly by the donor. It is not as if donors or UN agencies have access to a range of contractors that the government cannot access. The same people end up doing the work; the only question is who is paying them.

Thus the major difference between donors who channel the money through the government or those who go around it is how long it takes to contract the implementing partner and how much money is lost due to corruption or leakage. Assessments of risks and the challenges of channeling money through the government suffer from the use of a flawed counterfactual: a perfect system is assumed. But the outside channel is also flawed.

It would be a useful exercise to assess the time it takes different actors to move from the stage when funds become available to the stage when contracts have been signed. It is not at all clear that donors or UN agencies move more quickly than the government. Certainly in the case of Afghanistan, the government's two major programs—the National Emergency Employment Program and the National Solidarity Program—were implemented

more rapidly than any other major program, except for emergency food distribution and refugee repatriation programs.

A second useful exercise would be to compare the amount of money that reaches the beneficiaries when funds are channeled in different ways. Those who favor bypassing the government often cite corruption in their defense. These claims need to be accurately assessed and compared against the significant costs of going outside the government, including the cost structure of individual UN agencies and international NGOs. When a share of the funds is sliced off the top in a nontransparent fashion by a host government, it is referred to as corruption. When a UN agency or an international NGO takes 10, 15, or 20 percent as "overhead," no questions are asked by donors. This effect is compounded when funds cascade through several intermediaries, each charging their own overhead costs. When international technical assistance companies bill an overhead of 100 percent in addition to the amount paid to their contractors, it is often accepted as "industry standard." Private contractors can charge similarly high rates.

Donors may prefer to work outside the government in order to use their aid budget to pursue their foreign policy objectives or because of domestic political considerations—for example, in response to lobbying by their domestic aid stakeholders or to protect the interests of domestic companies who win contracts to provide goods and services to developing countries. They are certainly entitled to do so, but the consequences of these decisions, in terms of the negative impact on peacebuilding, should be understood, and the accuracy of the justifications for their policies should be examined. Channeling funding through the national government does not necessarily mean that fiduciary standards will be compromised or that planning will be less effective; various mechanisms can be put in place to ensure checks and balances in the system. These will be examined later in the chapter.

How Development Partners' Policies Undermine the Domestic Revenue System

The sustainability of the public finance system is undermined not only by the way development funds are allocated and spent. The policies that international organizations advocate, and the way they do business, can also undermine the creation of a sustainable revenue base.

The fundamental problem is the prevailing attitude of the majority of international actors: that revenue comes from donors, and taxes are to be avoided at both a personal and an institutional level. There is little expertise among international development agencies on revenue policy or revenue collection issues, let alone an understanding of the centrality of domestic revenue collection to sustainable development.[19] Donors generally insist that donor-funded activities be exempt from all taxes.[20] That is, donors, international organizations, and NGOs argue that, at a minimum, their international and local staff should be exempt from income tax; any materials they bring into the country should be exempt from customs or excise duties; and they should be exempt from any other government charges or fees (e.g., license or registration fees, inspection fees, etc.). In many cases, bilateral donors will further insist that these concessions be provided to any organization that they contract to perform a service. As a result, the single largest source of economic activity, and generally the largest employer of labor and other resources—the reconstruction effort—provides no revenue. Consequently, the rest of the economy, which is generally in a far more fragile state than the reconstruction and development sector, is burdened with the entire taxation effort.

This blanket demand for exemptions has several indirect impacts that substantially undermine the creation of a sustainable revenue system. First, in an environment of already weak administrative capacity, granting exemptions for certain groups adds an additional layer of complexity to the system, making it harder to administer. It also opens a new area for corruption by giving officials discretion to apply these exemptions more broadly than they were originally intended. These two impacts reduce the capacity of the system to operate effectively.

Second, other impacts reduce the amount of revenue collected. There is considerable anecdotal evidence of goods being brought into postconflict countries by exempt groups and then being sold in the market for use in other activities.[21] After all, the same lumber can be used to build emergency shelters or sold to build luxury homes. Moreover, granting exemptions to NGOs from either income or customs taxation gives these organizations a competitive advantage when bidding for contracts, thus inhibiting the development of the private sector, which cannot easily compete with the tax-exempt NGO.

Third, the domestic revenue system is undermined by donors that promote poor economic policies that do not foster long-term, sustainable economic growth. In many cases, the commercial arms of bilateral partners seek tax concessions for particular investors from their country.[22] In other cases they push for sweetheart deals, such as monopoly rights, for investors from their home countries. Although they meet the goals of the bilateral donor, such approaches do not serve the long-term needs of the country.

Fourth, this no-tax attitude is so pervasive that it manifests itself in demands for concessions or refusals to cooperate with the revenue system that go well beyond legally established conventions. In the case of the United Nations, the Convention on Privileges and Immunities relates to taxation; it does not apply to the payment of user fees for services provided. Yet in East Timor, UN staff regularly extended this blanket exemption to user fees and charges. On several occasions in Afghanistan, large and politically influential

NGOs had their cargoes held at customs points because they did not have the legally required documentation. Yet these cargoes were often cleared following the subtle application of diplomatic influence at varying pressure points. The prevailing attitude is that raising revenue is someone else's problem.

Opportunities to Move Forward

Tools for the International Community

If the international community wants to channel its resources through the government to leverage institution-building benefits, it has a number of options to ensure that the resources continue to be used appropriately. These interventions range from explicit red lines that, if crossed, will see support withdrawn through explicit and implicit conditionalities, to a partnership approach.

At one end of the spectrum, donors, collectively or individually, can impose a series of specific political conditions on the recipient country. They may include requirements that certain people be excluded from positions of authority (e.g., those who have committed human rights violations or who have criminal connections) or that the government not undertake certain activities (e.g., use of force) or employ discriminatory policies (e.g., access to public services determined by ethnicity or gender). Red lines are a negative sanction: the donor indicates that if the lines are crossed, it will disengage.

The next level of intervention is conditionalities. In contrast to red lines, they are generally positive. Donors indicate that if certain actions are taken or certain results obtained, then the recipient government will be rewarded. A common form of explicit conditionalities revolve around credits or grants from multilateral institutions, including the development banks and the IMF. When the recipient government meets certain conditions, funds are released. The conditionalities may be more implicit. For example, a donor may indicate that if the recipient government passes a particular budget, then funds will be released to support its implementation. As will be discussed below, there is scope to use explicit conditionalities to ensure that a transparent and accountable public finance system is built when funds are channeled through the government.

At the other end of the spectrum are partnerships that apply a consensus-based approach to the planning and implementation of expenditure. This could include some sort of expanded consultative group process in which donor representatives and their government counterparts sit along with representatives from relevant multilateral organizations on sector-based groups to plan the programs in each sector. After the sector programs are combined, the donor representatives and senior ministers meet to agree on the overall spending and implementation program. The sector-based consultative groups then assume a monitoring and reporting role, again based on a joint donor-government approach.

An Alternative Approach

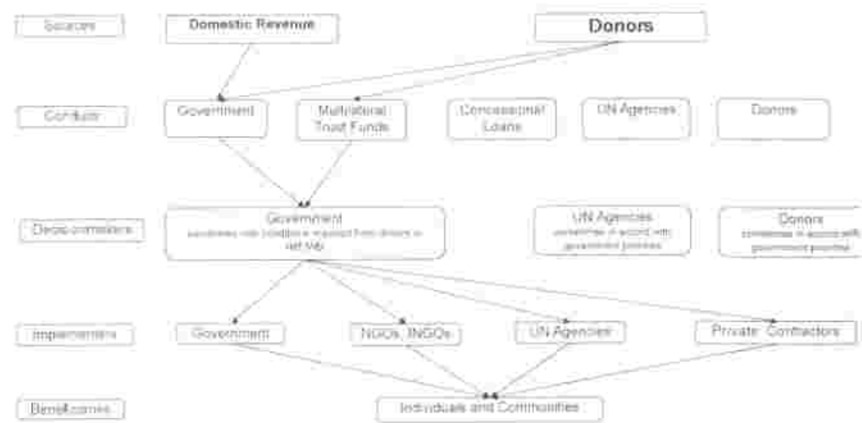
As an alternative to the financing modalities outlined earlier, the international community could use its assistance not only to deliver services to citizens, but to do so in a way that supports the development of sustainable state structures. Doing so requires a fundamental reorientation of the development community away from substituting for functions toward building the capacity of that state. Such a change will occur only if the current silo mentality is broken down and replaced by an approach that treats the country as a whole, providing assistance across domains, through government systems, with the flow of funds as the organizing principle. In order to do so, the international community will have to place a greater focus on helping the government to fulfill its key roles, rather than substituting for the government. The objective would be to support and build up the government through this process.

As outlined in Figure 4.3, this process would involve channeling international funds through a multilateral trust fund or directly to the government. Allocation decisions would be made through a unified process whereby donors would support the various government departments as they undertake expenditure planning. This process would conclude with a single budget for all expenditure, approved by both domestic political decisionmakers and representatives of the international community.[23]

This approach resembles the concept of shared sovereignty outlined by Stephen D. Krasner.[24] Although it may appear that requiring the agreement of the international community impinges on the sovereignty of the host government, in fact it serves to increase its sovereignty. The genuine counterfactual in most countries is that the host government has little real control. However, in contrast to Krasner's position, this approach would see the government increase its "share" of sovereignty over time, rather than having sovereignty over some domains shared indefinitely. As capacity increases, the overall goal would be full sovereignty.

Once the budget has been decided, the government would use a transparent process to contract program fulfillment to all implementing partners, including international NGOs, local NGOs, private companies, and UN agencies. This competition ensures that the government (and therefore the donors who are providing the funds) receives the best value for its money. One option is to require that for all expenditure resourced from a trust fund or provided through budget support there exists international management or oversight of internal procurement, financial management, and auditing

Figure 4.3 Government-Preferred Model



processes, enabling the government to operate as quickly and to equally highstandards as an international agency. Such an approach must be coupled with a strong skill transfer program to ensure that the process is sustainable in the long term.

This approach has been applied with some success in Afghanistan. The United Nations Office for Project Services (UNOPS) and Care International were contracted by the Afghan government to deliver aspects of the National Emergency Employment Program. In the case of the National Solidarity Program, more than twenty local and international NGOs were contracted to deliver services, and other organizations (first a UN agency and then a consortium of two private development agencies) were contracted to provide oversight of the twenty NGOs, while block grants were delivered directly to the villages.[25]

The benefits of this approach, in terms of delivering services, supporting the public finance system, and supporting statebuilding, are considerable. Rather than using resources to establish parallel systems of financial management, the international community could use these resources to support the development of this capacity within government, leveraging its financial contributions by making transparent financial management and reporting the conditions of receiving support. In this way, good practices can be entrenched while the volume of assistance is high, giving donors maximum leverage; as international aid declines and domestic revenues fund an increasing share of overall expenditure, the practices can continue. The same is true with regard to entrenching open and transparent procurement and tendering practices: donors can use their financial leverage to ensure that the government tenders out contracts to the most cost-efficient implementer.

By channeling resources in this way, government decisionmaking practices are strengthened, and concerns about ineffective expenditure are addressed by balancing needs across sectors, between groups, and between investment and operational expenditure. The legitimacy of the state grows as the government is seen to be providing services, which in turn will support the peace and security processes. Most importantly, the government and its institutions will have their capacity enhanced through a "learning by doing" approach—a far more effective teaching tool than abstract capacity-building methods with no real resources attached.

Service Delivery with Weak or Corrupt Governments

In certain instances channeling all resources through the government may not be possible or desirable, including cases in which a government is committing human rights violations, is incapable of administration, or is otherwise unwilling to engage constructively in policy formulation. Indeed, where services are severely limited or nonexistent and the needs are pressing, the benefits of delivering goods and services directly to people in need may outweigh the costs of bypassing state institutions. In these cases, there are alternatives to unconditional support for state institutions.

First, international actors enjoy a range of foreign policy tools, including sanctions and, in extremis, military intervention. Second, under the responsibility to protect doctrine, the international community has the option to provide humanitarian services directly. Such services are traditionally delivered independently of the government, through mechanisms such as refugee assistance and food delivery. Although such assistance may be necessary and helpful to avert imminent suffering and provide emergency assistance in the short term, there is a clear need to examine the medium- and longer-term impact of the ways in which such assistance is provided. Those providing goods must be aware of the impact on the domestic market for goods such as food and the impact on local coping mechanisms that may not reestablish themselves when the aid dwindles. A culture of dependency, or indeed lack of transparency in resource delivery, may become entrenched. As discussed above, the establishment of a large infrastructure of organizations and staff for delivery of such assistance may reduce the efficacy of state institutions. Thus, although such assistance may be necessary and unavoidable, mechanisms need to be identified to limit the adverse impacts of such assistance in the long term. It is worth noting that central to the responsibility to protect doctrine is the notion that the state is the primary duty-bearer of citizens' rights, and the international community should only step in to provide services with that in mind.

Where external actors have determined that humanitarian needs are substantial and pressing and that national service-delivery capacity is too weak

or corrupted, it may be useful to include a clear cost-benefit analysis of the institutional impact of providing such assistance. Determining the cost of service provision, as well as agreement on the scope of, equity of, and exit strategy for such assistance would be essential. Mechanisms might include policy frameworks such as the Strategic Partnership mechanism used in Afghanistan under the Taliban or the social funds widely used by donors to aggregate financing, policy preparation, and contracting modalities.

A useful tool might be to prepare a "substitution matrix" that would specify, for each function of the state, which actor has responsibility for its provision, for what period of time, to which citizens, at what level of service, and for what costs. At the same time, credible mechanisms for building state capacity to provide these functions could be identified. The period when political conditions do not permit direct engagement should be used for contingency planning and training for state capacity to be generated in the interim. For example, in a case in which the government in question is providing no health services, an agency may take over policy and implementation responsibility for that function for a specified period of time or until certain criteria are met. At the same time, credible capacity-building mechanisms could be developed, including preparation of policy frameworks and options and training for health workers and managers. If necessary, some of these measures could be undertaken outside the country. In cases in which the government is unable to keep the peace, security forces or peacekeepers might be deployed, but at the same time, pathways to create the capacity for policing and maintaining a national army should be identified.

The international community may also require that the government contract out some key services, using either domestic or internationally provided funds to finance such contracts. For example, management of revenue collection, security, or key national programs could be contracted to international firms or agencies. This approach might work in a case in which the government was relatively weak and the administration eroded and corrupt. In these cases, responsibility for financial management would be out of the state's hands, but the government could still participate in policy formulation.[26]

As discussed in the previous section, there is scope to develop creative strategies for routing resources through the government without giving up control and oversight. The approach described above proposes a system of dual controls whereby international assistance channeled through a multilateral trust fund or to the government is subject to verification by an external agent to ensure that proper accounting standards have been met prior to the release of funds. Similarly, procurement and auditing processes can be subjected to external verification. The government's internal budgeting process would, however, remain the locus for prioritization and planning for both domestic and international actors. This type of approach maintains oversight while building capacity for an effective, accountable, and transparent public expenditure system.

Some Specific Ways Forward

In addition to the alternative approach described earlier, several concrete changes could be considered in the area of public finance and the management of resources to advance the statebuilding agenda. Some of these options have been tried; others have not. Questions are often raised as to the applicability of these recommendations across different contexts. It is not the case that the prescriptions require strong and charismatic leadership from an individual, as they are designed to provide institutional mechanisms even where enlightened leadership is absent. Where governments are particularly corrupt, abusive, or predatory, the international community may need to build in additional safeguards, as described above. However, if the fact of a corrupt regime at one point in time is taken as a reason to perpetuate the elements of a vicious cycle, the conditions to alter the trajectory will never be created.

Making the budget the central instrument of strategy and policy formulation. As argued above, the budget is the framework through which essential policy trade-offs are made and strategies of the government articulated and thus the framework through which the government can coordinate decisionmaking. However, when the international community bypasses government institutions, making its aid allocation decisions unilaterally, the capability of the government to guide policymaking is undermined. Thus, the budget must be the central instrument of policy and strategy formulation for both internal and external actors. Although the annual rhythms of a budget may be insufficiently long-term for an institution-building agenda, a medium-term expenditure framework or a long-term statebuilding strategy may be an ideal framework through which to coordinate international strategy and policy in which the budget can be rooted.[27]

The international policy community is currently searching for mechanisms to ensure coherence in strategic planning across the domains of security, political, and development interventions. Although strategic planning exercises may be very useful and the participation of all key stakeholders in such processes essential, they must be linked to and underpinned by budgets in order to have traction. The budget and its associated processes and instruments provide the critical linkage between vision and strategy on the one hand and implementation on the other.

Making budget support more effective. In most postconflict countries, bilateral donors provide cash support to finance the budget of the host government. In the early years this can represent well over half of the resources for the ordinary or operating budget.[28] However, the uncoordinated and unpredictable way that assistance is provided often undermines efforts to build public finance capacity.

Rather than offering budget support that could reduce the imperative to collect domestic revenue, donors could offer collectively to tie their budget

contribution to the level of domestic revenue that is collected. For example, donors could agree that in the first three years of a new government they will match the domestic revenue collected, up to a certain level.[29]

By doing this, donors achieve several things. First, they provide enough certainty to the host government to allow effective budget planning. Second, they require the government to face the genuine trade-offs between spending programs. Third, they encourage the introduction of politically difficult revenue measures, because revenue collection now has the added benefit that each additional dollar of domestic revenue makes two additional dollars available for expenditure.

Such an approach also addresses many of the IMF-style conditionalities—measures such as establishing a large taxpayer unit or reforming the customs rates—that are designed to encourage the government to build a robust revenue system. However, a direct approach, in which the government is rewarded for actually collecting more revenue rather than for interim steps, would be more effective. Such an approach ensures that reforms to the revenue system are demand-driven and domestically owned rather than externally imposed, significantly enhancing their chances of success.

Adopting a comprehensive capacity-building approach that enhances leadership and management skills. Capacity building is an essential component of any statebuilding effort. However, the deployment of technical assistance through expensive companies in the name of capacity building, whose incentive is to perpetuate their own existence, does not tend to lead to the creation of capacity. A different approach is needed. Alternative mechanisms include a focus on enhancing leadership and management skills, a focus on rules for recruitment of capable leaders and managers, and twinning arrangements with officials from other countries who face similar challenges and experiences.

Both international and domestic actors must focus on building the core functions of a public finance system. Doing so will include a focus on the organization and institutions of the ministry of finance, but it is also linked to financial management systems and personnel across many functions and levels of government, including other line ministries, local administrations, and municipalities. As experience shows, institution building requires a focus on functions, systems, and rules as expressed in laws and manuals, as well as recruitment, training, and resourcing. Interventions must treat capacity building in a holistic manner, rather than relying on the provision of technical assistance alone.

A postconflict state is rarely a tabula rasa. Accordingly, approaches must be designed to suit the context and to build on existing institutions and capacities. Afghanistan, for example, had a system of public administration staffed with approximately 200,000 civil servants at the time the Bonn Agreement was concluded, making it essential to map and build on existing systems. In southern Sudan, the Comprehensive Peace Agreement of 2004 required the establishment of new public finance institutions drawn ostensibly from scratch; however, even in such a case, historical practices and institutional memories can be drawn upon in establishing new institutions.

The need to build on existing systems, some of which may be out of date or have been corrupted during the war years, must be balanced with introducing new technologies and practices aligned with international systems. Experience has shown that importing proprietary software packages immediately after conflict may be counterproductive; rather, the use of simple solutions on commonly used software platforms such as Microsoft Excel may be more appropriate.

Reducing coordination problems by managing donor participation. A particular problem in a fragile state is that every donor wants to operate in every sector. Regardless of the overall size of their financial contribution, each donor wants to spread that contribution over many different sectors in the developing country. Often they do so in response to NGOs and other lobbies in their home countries who are publicly critical of the donor government for failing to work in a particular sector. Not only does this dispersal of resources and effort across numerous sectors via minor projects lead to ineffective spending, it also produces a coordination nightmare that often falls on the government. In response to this, the government of Afghanistan came up with a system of coordination that included clear government-led rules for terms of donor engagement and systems and processes for simplifying, channeling, and monitoring donor activity that has been widely copied across other countries.

Contracting out for service provision. A key criticism of channeling funds through the government is that the government will use the funds to finance a bloated and inefficient bureaucracy. To counter this criticism and to ensure good value for the money, it is critical that the government build up a solid record of contracting out for service delivery at an early stage. It may be easier to do that in a postconflict or failed state environment, when the government's actual capacity to in-source activities is limited. As discussed above, this was the approach inherent in the National Emergency Employment Program and the National Solidarity Program taken by the Ministry of Rural Development and the Ministry of Public Works in Afghanistan. This approach also enhanced the extent to which the productive capacity, both in the NGO and private sector, was being used to deliver on the government's agenda rather than on the ad hoc ideas of bilateral donors.

Imposing taxes on international agencies. A final approach to building a sustainable public finance capacity is to remove tax and customs exemptions

enjoyed by international agencies and their affiliates and reduce the amount of budget support provided to offset this revenue. Such an intervention would not change the overall level of support provided to the country: the increased amounts needed by the international agency to cover the tax and customs obligations would be offset by the lower requirements for budget support. This approach would enhance the capacity of the domestic revenue system, as it would decrease administration costs and reduce the scope for corruption and abuse of the system.

There are some practical challenges in changing the machinery of government to move forward in this way. These challenges would be minor compared to the challenge of changing the prevailing attitude of the international community regarding the centrality of revenue collection and sustainable public finances to effective and lasting poverty reduction.

Conclusion

The focus of this chapter has been on conditions in postconflict and conflict-affected countries, but many of its lessons may be applicable to weak states that face many of the same constraints. There are significant differences between postconflict situations and weak states, of course, and accordingly, as with any institutional reform program, approaches must be designed to fit the context. However, a better understanding of approaches to building effective public finance institutions in any state, on the part of both domestic and international actors, could have immense payoffs. Many of the same issues addressed above occur with equal visibility in discussions on donor harmonization, policy coherence, and fragile states. In all these contexts, the use of public finance as the central lifeblood of an administrative and political system has equal potential and relevance.

Notes

1. Ashraf Ghani, Clare Lockhart, and Michael Carnahan, "An Agenda for State-building in the 21st Century," *Fletcher Forum of World Affairs* 30, no. 1 (Winter 2006): 101–123. See also the "Conclusion" by James Boyce and Madalene O'Donnell, in their *Peace and the Public Purse: Economic Policies for Postwar Statebuilding* (Boulder, CO: Lynne Rienner, 2007), pp. 271–296.

2. See Ghani, Lockhart, and Carnahan, "An Agenda," which draws on work with the Bonn Agreement and Afghanistan's National Development Framework, and proposes ten core functions that the state must perform in the contemporary world. Of these, the public finance function is one of the three foundational state functions.

3. See also Joel S. Hellman, Geraint Jones, and Daniel Kaufmann, *Seize the State, Seize the Day: State Capture, Corruption, and Influence in Transition*, Policy Research Working Paper no. 2444 (Washington, DC: World Bank, 2000).

4. For a more detailed description of this in practice, see the discussion of the mission planning and implementation arrangements for Kosovo, East Timor, and

Afghanistan in Conflict, Security and Development Group, *A Review of Peace Operations: A Case for Change* (London: Kings College, 2003).

5. See Ashraf Ghani, Clare Lockhart, and Michael Carnahan, "Closing the Sovereignty Gap: An Approach to State-Building," Working Paper no. 253 (London: Overseas Development Institute, 2005).

6. See the National Development Framework (2002) and Securing Afghanistan's Future (2005), which elaborate a framework, financing plan, and budget for a long-term statebuilding plan.

7. For example, in Afghanistan the size of the defense force was particularly contentious. Suggestions ranged from 20,000 to 700,000. The issue was not decided for several months, at which point a long-term vision for a force of 70,000 was accepted. Its composition remained ambiguous, which allowed the parties to move forward without getting bogged down in controversial details.

8. For a further discussion on the centrality of budgets to broader decision-making, see János Kornai, "The Soft Budget Constraint," *Kyklos* 39, no. 1 (1986): 3–30.

9. Indeed, it was interesting that the promise to reform customs drew considerable cheers from the delegates to the Constitutional Loya Jirga held in December 2003 in Afghanistan; their response demonstrated that the issue of public finance reform is related in the minds of the population to rules-based, transparent, and effective governance.

10. A more detailed discussion of this topic can be found in many places. Two examples are Ehtisham Ahmad, Piyush Desai, Thierry Kalfon, and Eivind Tandberg, "Priorities for Reform in Post-Conflict Finance Ministries," in *Reforming Fiscal and Economic Management in Afghanistan*, edited by Michael Carnahan, Nick Manning, Richard Bontjer, and Stephane Guimbert (Washington, DC: World Bank, 2004); and International Monetary Fund, *Rebuilding Fiscal Institutions in Post-Conflict Countries*, prepared by the Fiscal Affairs Department, approved by Teresa Ter-Minassian (Washington, DC, 2004).

11. In fact, comparing the amount of money spent on providing technical and physical assistance for revenue collection as a share of revenue collected does not provide flattering benefit-cost ratios. This figure is somewhat misleading, however, if the technical assistance is providing training—hence it will deliver an ongoing benefit. But technical assistance that does not deliver an ongoing increased capacity needs to be very carefully considered.

12. There does not even need to be a direct link for this issue to be problematic, given the fungibility of aid: loans need not have been specifically for the purchase of military hardware, but loans could have paid for teachers' salaries, allowing revenue that would have been spent on salaries to be spent on weapons.

13. There is a growing strand of literature that examines the extent to which "greed or grievances" leads to conflict. Although grievances (e.g., high inequality, chronic unemployment, ethnic and religious clashes) have traditionally been perceived as the primary factors, this literature argues that greed (access to finance, the capacity to gain from extractive industries, access to diaspora funding) could have greater explanatory power. See, for example, Gilles Carbonnier and Sarah Fleming, eds., *War, Money, and Survival* (Geneva: International Committee of the Red Cross, 2000); Paul Collier and Anke Hoeffler, "Greed and Grievance in Civil War," *Oxford Economic Papers* 56, no. 4 (2004): 563–595.

14. The challenges posed by high unemployment in the immediate period post-conflict require the consideration of different and innovative policy responses that have not traditionally found favor with economists. It is critical that the fundamental policy settings for economic growth are put in place, including a reliable property rights regime, stable and predictable monetary and fiscal policy, and sound regulatory policies. While these policies support and enable growth, they may not encourage rapid enough growth in inclusive employment-generating industries to stop the country from slipping back into conflict.

15. See conference proceeding in Ghani, Lockhart, and Carnahan, "An Agenda for State-building in the 21st Century."

16. Although IFIs do exert pressure on all governments to adopt specific economic policies, they generally play a positive role in building the public finance architecture. Because of their charter, they are required to enter into agreements with the national government, and grants and credits in most cases must flow through government systems and thus help build national institutions of public finance. Thus, the IFIs are not able to circumvent the government architecture in the same way that bilateral donors and other international development agencies do.

17. Project proposals often specify general areas, such as provision of potable water or emergency shelter, but give little more detail.

18. In the case of Cambodia, see "The Short Term Impact of UNTAC on Cambodia," unpublished report prepared by the Economic Adviser's Office, UNTAC, 1992; and for East Timor, see Michael Carnahan, William Durch, and Scott Gilmore, *The Economic Impact of Peacekeeping: Final Report*, prepared as part of the Economic Impact of Peacekeeping Project commissioned by PBPS/DPKO, published in partnership with Peace Dividend Trust, March 2006.

19. This comment does not apply to the Fiscal Affairs Division of the IMF, which has a strong understanding of these issues, or to some parts of the World Bank or the Asian Development Bank.

20. The way in which different donors request different exemptions also highlights their lack of understanding of revenue systems. First, while they demand exemptions for their staff from income taxation, they do not, in general, demand exemptions for their staff from indirect taxation (e.g., services tax). Similarly, while they insist on exemptions for their own staff and for their contractors, they vary in how far down the subcontracting chain they require exemptions. Yet if their primary argument that aid dollars should not be used for paying domestic taxes was to be applied, then these exemptions would need to be traced through the entire economy.

21. In East Timor the reselling of tax-exempt alcohol led to the introduction of a tax stamp system so that tax inspectors in the marketplace could quickly identify alcohol on which tax had not been paid. In Sierra Leone entire markets have appeared selling tax-exempt items obtained from UN peacekeepers.

22. Tax concessions undermine a sustainable revenue system, since granting a concession to one industry effectively imposes a penalty on all other industries. Conceptually, the best system for both economic development and revenue generation involves the lowest possible rate structure and the broadest possible tax base, both consistent with the revenue needs of the state.

23. Often there is a distinction between what is referred to as the operating or recurrent budget and the development or investment budget. This distinction is not consistent with best practice in budgeting. It is often used simply because the donors will not allow the government much say in the development expenditure. So the development budget simply represents a catalog of what donors are going to do anyway, rather than a process and document that reflects government decisions on spending priorities.

24. Stephen D. Krasner, "Sharing Sovereignty: New Institutions for Collapsed and Failing States," *International Security* 29, no. 2 (Fall 2004): 85–120.

25. A particular challenge in this regard is the attitude of many international organizations, which see themselves as part of a vertically integrated industry—they identify a need, design a project, advocate for the funding of that project, obtain the funding through their own organization, and then contract for the project's implementation. Building a sustainable state actually requires that this vertical integration be removed, with competition introduced at each level of the process, from competition over priorities to competition over the implementer. There is no natural reason why a group that is good at designing projects will also be good at implementing them.

26. See Michael McGovern's discussion of the Governance and Economic Management Assistance Program in "Liberia: The Risks of Rebuilding a Shadow State," Chapter 14 in this volume, for an example of one such approach.

27. Ashraf Ghani, Clare Lockhart, and Michael Carnahan, *Closing the Sovereignty Gap: An Approach to State-Building*, Working Paper no. 253 (London: Overseas Development Institute, September 2005).

28. The operating budget pays civil and military salaries and funds the ongoing operational costs of the government. In the case of East Timor, budget support represented around half of the resources needed to fund the government in the first three years. In Afghanistan, budget support funded around 75 percent of the operating budget in 2002, just under two-thirds in 2003, and around 50 percent in 2004.

29. For a more detailed discussion on this issue see, for example, Michael Carnahan, "Options for Revenue Generation in Post-Conflict Environments," *Public Finance in Post-Conflict Environments: A Policy Paper Series*, Center on International Cooperation, New York, and the Political Economy Research Institute, Amherst, MA, 2007.

5

Postconflict Economic Policy

Paul Collier

Civil wars occur disproportionately in low-income countries with stagnant or declining economies. Superficially, the postconflict situation in such countries looks very similar to the general problem of statebuilding in low-income environments with poor policies, weak institutions, and limited local capacity. Indeed, until recently, the organizations dedicated to economic development did not systematically distinguish postconflict settings as requiring a distinctive approach. Yet policy in the postconflict phase needs to be distinctive, both that of the government and that of the donor agencies. It should not be simply development as usual. Of course, policy always needs to be tailored to circumstances, and circumstances differ massively between postconflict countries. The purpose of this chapter is not to lay out postconflict policies for economic recovery as a set of iron principles, but rather to show some features that generally do need to differ systematically from those appropriate for equally poor countries that are not postconflict.

The suggestions in this chapter are not a substitute for thorough knowledge of a particular situation and may well be seriously inappropriate in particular instances. They are based on statistical analysis of what is currently an inevitably limited number of postconflict observations. Nevertheless, they may be a useful supplement to practitioner expertise, which is itself necessarily limited: service in the reconstruction of East Timor may have only limited applicability to the reconstruction of Afghanistan. The new UN Peacebuilding Commission provides the opportunity to introduce a greater degree of standardization into postconflict interventions while differentiating them from other situations in which the state is in some sense "failing." Indeed, that will presumably be one of its tasks.

A key reason why policy should be distinctive in postconflict settings is that the legacy of civil war implies that objectives should be distinctive. One