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## **Postconflict Countries** Strategy for Rebuilding Fiscal Institutions

Sanjeev Gupta, Shamsuddin Tareq,  
Benedict Clements, Alex Segura-Ubiergo,  
and Rina Bhattacharya

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### **Abstract**

This paper reviews the challenges and experiences in rebuilding fiscal institutions in postconflict environments, based on advice from the IMF's Fiscal Affairs Department to selected countries. The recommended strategy involved a three-step process of (i) creating a proper legal framework for fiscal management, (ii) establishing a central fiscal authority and a mechanism for co-ordinating foreign assistance, and (iii) designing appropriate tax policies while simultaneously creating simple tax administration and expenditure management arrangements. The advice was tailored to the circumstances of postconflict countries, and in some cases involved transitional measures that were not first best from an efficiency standpoint. In a similar vein, recommendations on revenue administration and expenditure management focused on the most basic tasks and procedures. In providing advice, care was taken to ensure that these measures were consistent with the eventual transformation to a modern fiscal management system.

**Keywords:** fiscal policy, tax, institutions, conflict

**JEL classification:** H30, K34, O43

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## List of acronyms

IMF	International Monetary Fund
LTU	Large Taxpayers Unit
MDRI	Multilateral Debt Relief Initiative
PEM	public expenditure management
TA	technical assistance (IMF mission)
TIN	taxpayer identification number
TSA	Treasury Single Account

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UNU World Institute for Development Economics Research (UNU-WIDER)  
Katajanokanlaituri 6 B, 00160 Helsinki, Finland

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## **1 Introduction**

The proliferation of violent conflicts over the last two decades has taken a heavy toll on life and property. The effects of conflict have often spilled across national boundaries, for example through the disruption of economic activity and the influx of refugees. Furthermore, countries in conflict have a high tendency to relapse into subsequent conflicts.<sup>1</sup> As such, the legacy of conflict—and its adverse effects for socioeconomic development—have been difficult for many countries to escape.

One of the most destructive effects of conflicts is the damage they inflict on the social, economic, legal, and political organization of a society, that is, its ‘institutions’. In particular, conflicts affect at least five market-supporting institutions: property rights, regulatory institutions, institutions for macroeconomic stabilization, institutions for social insurance, and institutions for conflict management (Rodrik 1999). Recent empirical evidence shows a strong relationship between these market-supporting institutions and economic growth (North 1990; Olsen 1993; Rodrik et al. 2002; Acemoglu et al. 2003; Rodrik 2004). Hence, institutional reconstruction and development is one of the key priorities in the postconflict era. Re-establishing institutions can help to sustain peace by laying the groundwork for a resumption of economic activity. Sustained peace, in turn, can further accelerate the process of recovery in the aftermath of conflict.

This paper focuses on a small but important set of economic institutions, namely, those in the fiscal area. The paper reviews the challenges and experiences in institution and capacity building in the fiscal area in postconflict countries. The paper is organized as follows. Section 2 reviews the literature on some of the key aspects of rebuilding economic institutions in postconflict environments. Section 3 provides an overview of the macroeconomic and fiscal consequences of conflict by examining changes in key macroeconomic variables immediately before, at the end of, and the latest year available in a sample of postconflict countries; Section 4 discusses experiences in Re-establishing fiscal management in postconflict countries and analyzes, on the basis of the advice provided by the IMF, key priorities for rebuilding fiscal institutions in the early postconflict period; and Section 5 presents a summary and conclusions.

## **2 Review of the literature**

The literature on postconflict aid highlights the important role of rebuilding institutions to facilitate the resumption of economic development and the effective absorption and management of aid inflows. The pattern observed in many postconflict countries is for

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<sup>1</sup> Bigombe et al. (2000).

aid to surge immediately after the cessation of hostilities and gradually taper off thereafter. Collier and Hoeffler (2002a) argue that this pattern of aid flow leaves much to be desired, as the capacity of these countries to absorb aid is rather low in the early postconflict period. This is partly due to weak political and administrative capacity.<sup>2</sup> In this regard, a framework for stabilization, recovery, and development should center on three pillars: (a) rebuilding the state and its key institutions; (b) jump-starting the economy; and (c) addressing urgent needs and reconstructing communities (Michailof et al. 2002; Addison 2003). An important component of this framework is restoring state capacity for macroeconomic management and fiscal operations. Postconflict countries require assistance in the areas of budget formulation, execution, and reporting, as well as in design and implementation of critical reforms. In the immediate aftermath of the crisis, there is also an urgent need to strengthen the capacity of the state to generate internal resources through taxation to finance the reconstruction of the economy and ensure delivery of essential services. Thus, an immediate priority in the early postconflict phase should be on rebuilding revenue administration and systems.

Sound policies are also important for success in the postconflict period. For example, sound macroeconomic policies are helpful for securing growth and avoiding a relapse into conflict.<sup>3</sup> At the same time, there is a ‘virtuous circle’ between institution building and the implementation of good economic policies (Addison 2003). For example, improvements in public expenditure management and tax administration can help establish fiscal discipline. This, in turn, can lead to success in achieving macroeconomic stabilization and growth, thereby providing a more stable and fruitful environment for further institution building. Strengthening institutions and economic policies reduces the risk of future conflicts. Without appropriate institutions and sound policies, recovery may not be broad-based, high levels of poverty are likely to persist, and the probability of a return to conflict will remain high (Ibid.).<sup>4</sup> Establishing appropriate institutions and good economic policies is also necessary for attracting private investment in postconflict countries. Postconflict countries need strong and sustained increases in private investment to support broad-based economic recovery (Ibid.). Catalyzing this private investment requires the concomitant strengthening of institutions and the policy environment.

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<sup>2</sup> However, a recent paper by Suhrke et al. (2004) challenges these findings.

<sup>3</sup> Fallon et al. (2004) analyze the impact of conflict on economic development in 23 conflict-affected countries and conclude that in the post-1990 period, sound macroeconomic policy stance enabled a faster economic recovery after the conflict. Collier and Hoeffler (2002b) also lend support to this finding.

<sup>4</sup> Collier and Hoeffler (2002b) identify three policy-dependent risks of conflict, the most powerful of which is dependence on natural resource rents. Their analysis indicates that the risk of conflict is highest when natural resource exports constitute 25-30 per cent of GDP.

In sum, postconflict peace and economic recovery require improvements in economic policies and institution building in a range of areas, spanning from merely establishing the rule of law to restoring capacity for policy formulation and implementation. Even within the area of macroeconomic management, the needs for capacity building could be very extensive. For example, some countries may need to introduce a new currency or establish new institutions, such as a central bank. The need for institution building is most pervasive in scope for countries that are newly formed as a result of conflicts. Others may need assistance with budget formulation, execution, and reporting. Still others may require help in strengthening statistical capacity to assist in macroeconomic management. The focus of this paper is on institution building in the fiscal area.

### **3 Macroeconomic and fiscal settings in postconflict countries**

The challenges facing postconflict countries can be gauged by economic conditions confronting them in the aftermath of a conflict.<sup>5</sup> Figures 1–7 present information on macroeconomic and fiscal conditions in the year before the start of the conflict, at the end of the conflict, and for the latest year available.<sup>6</sup> Our sample covers 17 countries and conflict episodes which spanned the period 1990–2006. However, these figures only include countries that existed before the conflict, and thus do not cover countries or entities that were born out of these conflicts (e.g., Timor Leste, Kosovo).

Macroeconomic imbalances—already severe at the onset of the conflict—were generally exacerbated by the hostilities. On average, real GDP fell significantly in these countries during the conflict (Figures 1 and 2). This is consistent with earlier studies on the economic consequences of conflict.<sup>7</sup> Both real GDP as well as real per capita GDP were below their preconflict levels when the first IMF TA mission took place. Inflation, already at high levels before the onset of hostilities, increased further during the conflict

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<sup>5</sup> For a more comprehensive study of the relationship between conflict episodes and economic performance; see Staines (2004). The author documents how recent conflicts have become shorter but have more severe contractions in economic activity followed by a stronger recovery of growth.

<sup>6</sup> In Figures 1–7, ‘end of conflict’ refers to the year before the first IMF TA (technical assistance) mission on fiscal issues was fielded, except for Tajikistan where it refers to the year of the first TA mission. This year provides the backdrop for the macroeconomic situation against which postconflict TA was provided. In most cases, this is the last year of the conflict or later. However, in 4 (of the 17) countries in the sample, the first mission took place during the conflict.

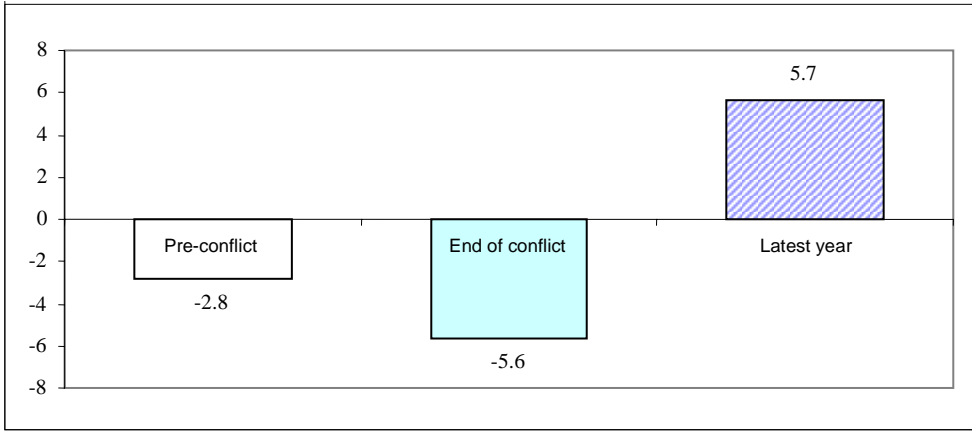
This analysis is based on a subset of 17 countries to the extent that data are available from the 28 postconflict countries identified in Section 2. These 17 countries are analyzed in Section 4. They comprise Afghanistan, Albania, Bosnia and Herzegovina, Cambodia, Croatia, Democratic Republic of the Congo, Kosovo, Lebanon, Liberia, Mozambique, Rwanda, Serbia and Montenegro, Sierra Leone, Tajikistan, Timor Leste, Yemen, and West Bank and Gaza Strip.

The analysis presented in this section should be interpreted with caution. The evolution of the macroeconomic variables over the period covered by the analysis is influenced by a host of factors other than the conflict. In addition, the sample size for some of the macroeconomic and fiscal variables differs.

<sup>7</sup> See Collier et al. (2003); Gupta et al. (2004).

episode (Figure 3). In part, this owed to the failure to rein in burgeoning budget deficits (see below). The level of international reserves (in months of total imports) was also lower than before the conflict (Figure 4).

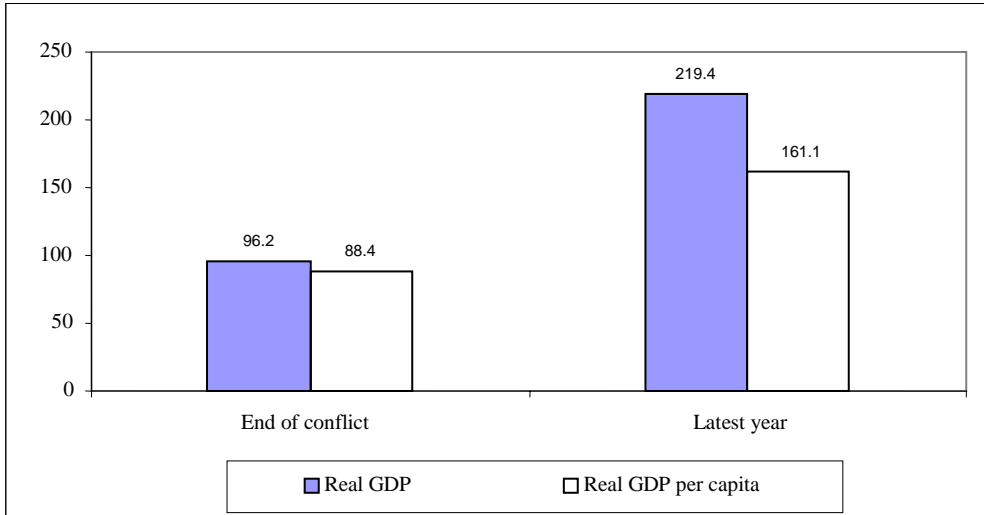
Figure 1 Real GDP growth in selected postconflict countries\* (annual percentage change)



Sources: IMF, *World Economic Outlook* database 2007; and World Bank, *World Development Indicators* database.

Note: \* Based on a sample of 13 countries: Albania, Bosnia and Herzegovina, Cambodia, Democratic Republic of Congo, Croatia, Lebanon, Liberia, Mozambique, Rwanda, Serbia and Montenegro, Sierra Leone, Tajikistan, and Yemen. 'Preconflict' refers to the year before the beginning of a conflict, except for Albania and Croatia where it refers to 2 years before the conflict; 'end of conflict' refers to the year before the first IMF TA mission on fiscal issues was fielded, except for Tajikistan where it refers to the year of the TA mission; 'latest year' refers to 2006 or the most recent year for which data are available. For Lebanon and Serbia and Montenegro, the latest year refers to 2005.

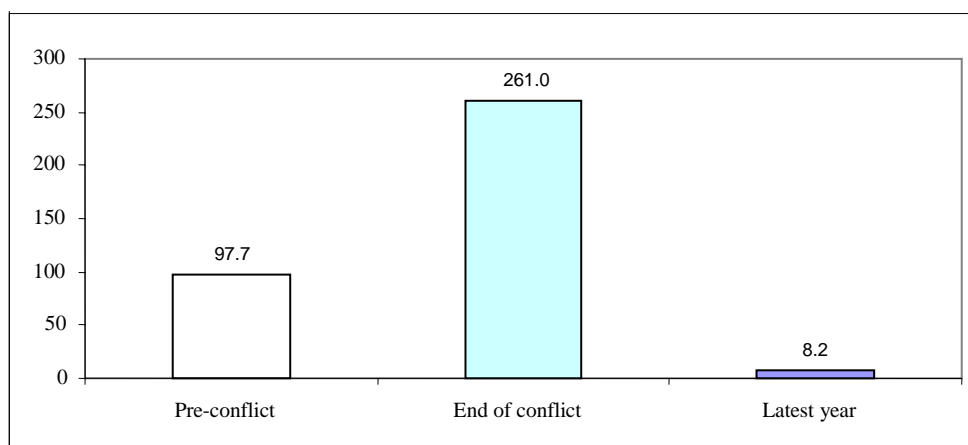
Figure 2 Real GDP and GDP per capita in selected postconflict countries\* (index, preconflict = 100)



Sources: IMF, *World Economic Outlook* database 2007; and World Bank, *World Development Indicators* database.

Note: \* Based on a sample of 13 countries. See Figure 1 for country coverage and for definition of preconflict, end of conflict, and latest year.

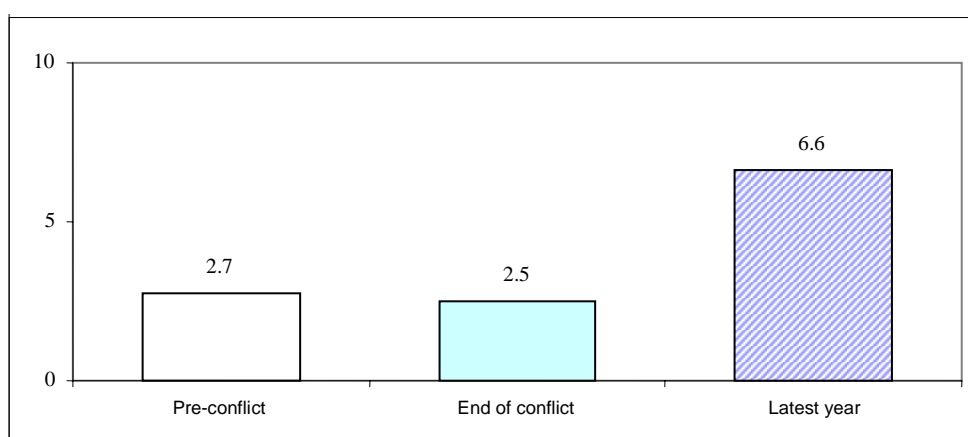
Figure 3 Consumer price inflation in selected postconflict countries\*  
(annual percentage change)



Sources: IMF, *World Economic Outlook* database 2007; and World Bank, *World Development Indicators* database.

Note: \* Based on a sample of 11 countries: Afghanistan, Albania, Cambodia, Democratic Republic of Congo, Croatia, Lebanon, Mozambique, Rwanda, Sierra Leone, Tajikistan, and Yemen. See Figure 1 for definition of preconflict, end of conflict, and latest year.

Figure 4 International reserve stock in selected postconflict countries\*  
(in month of total import)

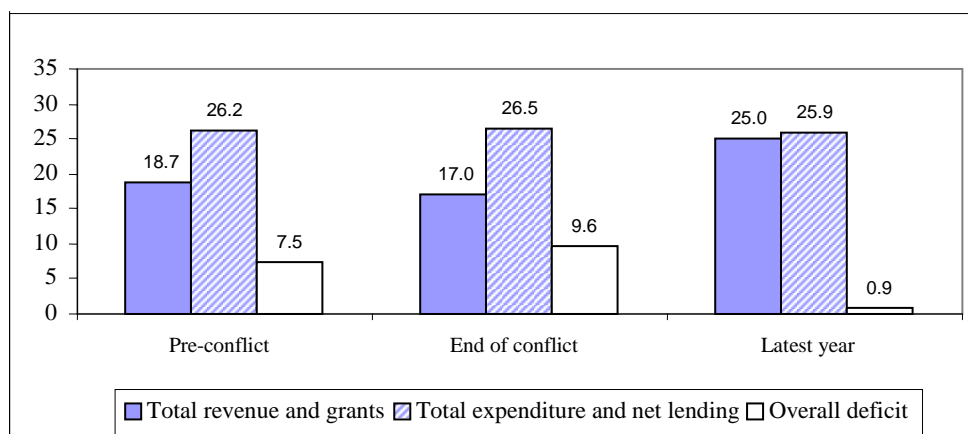


Source: IMF *World Economic Outlook* database 2007.

Note: \* Based on a sample of 7 countries: Albania, Democratic Republic of Congo, Lebanon, Mozambique, Rwanda, Sierra Leone, and Yemen. See Figure 1 for definition of preconflict, end of conflict, and latest year.

Macroeconomic challenges were particularly severe in the fiscal area. Fiscal deficits (including grants) at the time of the first IMF TA mission were substantially higher than at the start of hostilities (Figure 5). This expansion in the deficit was due to a substantial slippage in the revenue effort, as government spending remained relatively stable. Reductions in outlays on wages and salaries were especially sharp, while military spending increased (Figure 6). With net foreign financing falling sharply, the bulk of the additional financing required by the budget was met from domestic sources (Figure 7). Consequently, the domestic financing requirement rose to about 9 per cent of GDP.

Figure 5 Fiscal aggregates in selected postconflict countries\*  
(in per cent of GDP)



Sources: National authorities; and IMF staff estimates.

Note: \* Based on a sample of 9 countries: Albania, Cambodia, Democratic Republic of Congo, Lebanon, Mozambique, Rwanda, Sierra Leone, Tajikistan, and Yemen. See Figure 1 for definition of preconflict, end of conflict, and latest year.

Figure 6 Government spending in selected postconflict countries\*  
(in per cent of GDP)



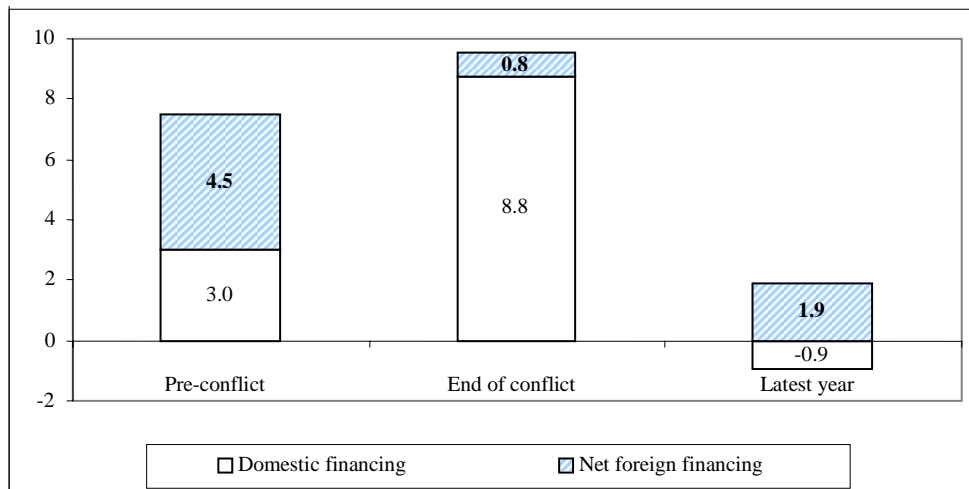
Sources: National authorities; and IMF staff estimates.

Note: \* Based on a sample of 7 countries: Albania, Cambodia, Democratic Republic of Congo, Mozambique, Rwanda, Sierra Leone, and Yemen. See Figure 1 for definition of preconflict, end of conflict, and latest year.

Macroeconomic conditions in these countries have improved significantly in recent years. The latest available information indicates that real GDP growth averaged about 6 per cent, with all countries in the sample registering positive growth rates. Real GDP was more than double its preconflict level, with real per capita GDP more than 60 per cent higher. There has also been a dramatic reduction in inflation and a significant increase in international reserves.



Figure 7 Financing of the budget in selected postconflict countries\*  
(in per cent of GDP)



Sources: National authorities; and IMF staff estimates.

Note: \* Based on a sample of 9 countries: Albania, Cambodia, Democratic Republic of Congo, Lebanon, Mozambique, Rwanda, Sierra Leone, Tajikistan, and Yemen. See Figure 1 for definition of preconflict, end of conflict, and latest year. Privatization receipts are included in domestic financing, and net foreign financing excludes grants.

The fiscal position has also improved in recent years. Budget deficits fell significantly with some countries benefiting from debt relief under the Multilateral Debt Relief Initiative (MDRI). Net external financing of the budget increased sharply, enabling countries to repay some of their domestic debt. Revenues rebounded and rose as a share of GDP, surpassing their preconflict levels. Total government spending remained largely unchanged but military spending declined, to less than half its preconflict level. As such, it appears that the peace dividend was used by countries to address fiscal imbalances as well as to attend to pressing social needs.<sup>8</sup>

#### 4 Re-establishing fiscal management and institutions in postconflict countries

This section discusses the strategies recommended for re-establishing fiscal management and rebuilding fiscal institutions in postconflict countries, based on advice to selected countries from the IMF's Fiscal Affairs Department. While the paper attempts to paint a broad picture of the nature of the advice, there were differences in recommendations across countries. This caveat is important, especially when specific measures are discussed. In addition, the description of advice on the design of fiscal institutions does not assess countries' track record in implementing these recommendations, since this would go beyond the scope of the present study and involve a more in-depth assessment of developments in each of the countries in the sample. Finally, it is also important to note that establishing or rebuilding fiscal

<sup>8</sup> For an examination of the impact of conflict on social indicators, see Gupta et al. (2004).

institutions also depends on successful implementation of reforms in other areas, especially with regard to the strengthening of the central bank and the central statistics office, and to the successful development—particularly in newly formed countries—of an efficient banking system capable of providing cashier and payment facilities throughout the country to assist in the effective delivery of government services.

The analysis below suggests a general strategy for the rebuilding of fiscal institutions in the wake of conflict. The three-step process appears as follows:

- first, create a proper legal framework for fiscal policy;
- second, establish a central fiscal authority and a mechanism for co-ordinating foreign assistance; and
- third, implement necessary changes in revenue policies and create simple administrative arrangements in revenue administration and public expenditure management (PEM) that effectively leverage scarce human resources.

The sequencing of the steps generally followed the pattern described above, but not always. For example, while establishing a fiscal authority is a necessary early step in countries where no such institution existed before, setting up of the authority could take some time. However, certain tax administration procedures may need to be promulgated even if the authority is not fully functional. These include, for example, procedures for collection and payment of taxes. On the expenditure side, procedures for government payments such as for salaries and purchases of goods and services need to be put in place urgently and may not await the setting up of a fiscal authority. In some cases, this had to be done before a meaningful budget was established.

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

- i) Conflicts that led to the emergence of new countries or took place immediately after the creation of a new country. These countries followed closely the three-step framework described above.
- ii) Conflicts in pre-existing countries with widespread institutional damage and social disruption. These countries also followed the three-step framework but the sequencing was not always the same. In some cases, the first priority was to rebuild the basic infrastructure of the finance ministry, and only later was emphasis placed on creating a proper legal framework for fiscal policy. However, in countries where the legal framework for budget preparation and execution was basically sound (even if it had not been applied for many years), other important legal reforms were recommended (such as reforms for the income tax law, foreign and domestic private investment law, and customs service law).

- iii) Conflicts in pre-existing countries with a low to moderate degree of institutional and social disruption. In cases where the fiscal institutions emerged from the conflict relatively unscathed, the focus was instead on the third step. In one case the immediate priorities included (i) restaffing all tax administration offices; (ii) lowering the VAT reporting threshold; and (iii) securing the co-operation of banks in accepting tax payments. In another case the focus was on simplifying the tax system to facilitate the transition to a more modernized and market-friendly tax environment.

The approach to rebuilding fiscal institutions was also shaped by the role of the international community. In some newly formed countries, the UN was responsible for running government operations, which influenced the nature of advice given. In these countries, a special challenge was to ensure that local capacity was in place before responsibility was handed over to national administrators.

The postconflict era sometimes provided an opportunity for bold changes. In some cases, there was openness to new approaches that had been previously rejected as being politically, legally, or administratively infeasible. Thus, while administrative capacity may have been depleted, in some cases the immediate postconflict period provided an opportunity to put in place major improvements in policies and institutions relative to the preconflict era.

#### **4.1 Create a proper legal framework for fiscal policy**

The fiscal operations in any country are generally anchored in two main legal sources: the constitution, and tax and budget laws. The constitution generally specifies the division of taxing powers between different levels of government, and between the executive, the legislative, and the judiciary. It also determines the nature of emergency powers available to the executive. Tax laws are critical to make tax policy legally enforceable. They define the powers of the tax administration to collect information about taxpayers, and the administrative actions that can be taken against individuals or entities that evade taxes or accumulate tax arrears. Budget and public financial management laws are also indispensable to ensure that the fiscal authority is vested with the legal authority to control and manage public spending.

The creation of a consolidated package of customs and tax laws, regulations, and directives was often a measure of immediate importance in postconflict countries. In countries where preconflict legislation was not reasonably sound, a key objective was to simplify tax legislation and procedures for revenue collection, with a view to making them more transparent and easier to implement and administer. In a number of cases, the complexity of existing legislation made tax laws difficult to implement, especially in light of the limited administrative capacity prevailing in a postconflict environment. For example, in many cases the tax code included a wide variety of duties, tariff rates, and

special taxes and surcharges. The mismatch between administrative capacity and the complexity of the existing laws and regulations often led to inevitable efficiency losses, mistakes in tax assessments, and difficulties in tax collection.

A number of countries viewed the reform of customs and tax laws as crucial. In one country the authorities initiated a comprehensive programme to reduce tax exemptions and combat tax evasion, including through a review of special conventions in the investment code. In another country a new, simplified tariff law was adopted to reduce the scope for smuggling and fraud. In yet another country legislation was introduced to radically simplify the real estate property tax.<sup>9</sup> The nature and scope of these laws varied across countries. On occasion, countries adopted more formal organic laws; in other instances, where speedier action was needed, decrees were used to modify the income tax law.<sup>10</sup> In newly created countries, the lack of a prior legal framework meant that substantial resources needed to be devoted to this purpose.

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

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

Re-establishing the authority of the government to collect taxes and preparing an adequate budget law formed an important component of the strategy to re-establish the rule of law. The success or failure of these tax and budget reforms themselves depended

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<sup>9</sup> This tax accounted for less than two per cent of total government revenue, and yet the law prescribed burdensome procedures for its administration. Revenue agencies had to adjust each year the taxable value of 1.6 million properties, based on information collected from 160 counties on sales of new buildings.

<sup>10</sup> Unlike organic laws, which generally require parliamentary approval, decrees are signed directly by the executive and can therefore be implemented quickly.

heavily on the capacity of the state to Re-establish order and develop a system of judicial sanctions to penalize those who evade them (Maravall and Przeworski 2003). Therefore, ensuring that key legislation was in place authorizing the tax and customs administrations to perform their basic duties was high on the list of priorities. In some countries, the revenue administrations were set up at the same time as other national government entities in the executive, legislative and judicial branches. Because of their importance in terms of securing the revenue needed to finance the government's operations, authorization for their establishment could not wait until the legislative branch was fully operating, and was thus done by government decree.

The underlying strategy was to start simple. This implied that budget and tax laws, for example, were made very basic and short. Over time, these were expanded. This allowed for greater local ownership as the details of these laws were fleshed out over time and as capacity improved.

#### **4.2 Establish a central fiscal authority and a mechanism for co-ordinating foreign assistance**

Strengthening the central fiscal authority, or establishing one from scratch in new countries, was an essential step in all cases. In effect, newly established countries needed to create a finance ministry. For existing countries, a finance ministry needs to be adequately strengthened so that it can perform a number of basic tasks essential for macrofiscal management. Although the precise institutional structure, powers, and responsibilities of newly created institutions varied across countries, based on country-specific circumstances, they shared a number of common objectives. One important objective was to ensure that fiscal decisions were not taken in an ad hoc manner. A second objective was establishing transparency in fiscal operations. A third objective was to ensure a minimum level of revenue collection. A fourth objective was to ensure that government spending was consistent with the government's priorities. Establishing a set of procedures to effectively control government spending or establish accountability was important for efficient service delivery and to assure donors that funds provided for relief and reconstruction were being used as intended. Given the dearth of administrative and technical capacity available within these countries, it was recognized that the institutions should have a simple structure.<sup>11</sup>

The fiscal authority was intended to perform three basic functions. These were:

- i) develop a fiscal strategy and monitor its impact on the economy;

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<sup>11</sup> In a related vein, in two cases where issues of fiscal federalism were particularly important, it was argued that fiscal decentralization would need to wait, as the necessary institutions were not yet in place to ensure that this decentralization would be consistent with sound macrofiscal management of general government operations.

- ii) formulate expenditure policy and execute the budget; and
- iii) formulate tax policy and collect revenues.

The fiscal authority normally consisted of four main operational departments:

- a. A *budget department* with the responsibility to co-ordinate the overall expenditure programme and prepare fiscal projections and budget execution reports. With respect to budget formulation, the department issues the budget circular to spending agencies, indicating a budget ceiling and requesting submission of spending plans. These plans are then reviewed for credibility and consistency, and adjusted where agency submissions are incompatible with aggregate budgetary ceilings or policy priorities. In the area of tax policy, the budget department consults with its counterparts in tax administration to prepare projections for revenues, and assesses the impact of different tax policy changes on these receipts. This information, along with fiscal projections and budget execution reports, is then provided to the appropriate decision-making authority, so as to enable it to make fiscal policy decisions in an orderly and systematic fashion.
- b. A *treasury department* responsible for controlling spending and ensuring that it is properly accounted for. The department performs the dual functions of providing spending authorization to spending agencies (based on the approved budget) and making sure that spending is properly recorded. It is also charged with oversight of the movement of collected government revenues into treasury bank accounts, the rationalization of government banking arrangements to promote transparent recording of transactions, and workable strategies for cash management. The department also prepares periodic expenditure reports to enable the spending agencies and the budget department to effectively monitor spending during the course of the year.
- c. Separate *customs and domestic tax administration departments* responsible for implementing tax policy and collecting tax revenues. In newly created countries, tax policy options were constrained by administrative capacity and, in most cases, it was decided that tax policy and administration should be under unified management. Thus, these departments were also entrusted with responsibility for tax policy. One issue that often arose in this context was whether customs and domestic tax administration should be merged in order to simplify administration. The modest amount of resources expected from domestic taxes was cited by the authorities, in some cases, as an argument in favor of unifying administration. On the other hand, the procedures for collecting these revenues differ substantially; in light of this, IMF TA argued in favor of establishing separate customs and domestic tax administration departments, with the former entrusted with the responsibility for collecting trade taxes.

In some cases a macrofiscal unit was also recommended to help support policy formulation. This unit was recommended for (i) preparing a medium-term expenditure framework; (ii) conducting debt sustainability analysis; (iii) analyzing tax policy issues; and (iv) assessing structural fiscal issues such as pension reform.

A mechanism was needed in many countries to facilitate co-ordination of donor funds. In some instances, there were no procedural arrangements for the use of foreign aid, and insufficient co-ordination between donor agencies and the ministry of finance. In these cases, there was often a disconnect between expenditure needs and budgetary outlays. Better co-ordination was thus seen as essential for both donors and recipient countries. From the perspective of the donors, information on activities of other donors in specific areas was useful in framing their own assistance strategies and to avoid duplication. For the recipients, such a mechanism provided the spending agencies with information on activities of donors in their area of competence, and thus helped in framing their plans for spending financed from domestic resources. In addition, donor-financed projects also gave rise to future recurrent spending requirements, which needed to be incorporated in future spending plans. In some countries, a separate unit was set up to co-ordinate with donors, often as part of the finance ministry or its equivalent institution. In other cases, however, a multi-donor trust fund was set up that carried out the co-ordination function.

In some cases, the establishment and consolidation of power of the central fiscal authority created challenges for the difficult political equilibria reached during the resolution of the conflict. In two cases, issues of fiscal federalism/decentralization quickly acquired importance, given the strength of sub-national/regional political forces with strong secessionist roots. In these cases, it became important to follow a strategy where the decentralization necessary to keep the peace did not endanger economic reforms and fiscal management.

#### **4.3 Implement necessary changes in revenue policies and create simple administrative arrangements that effectively leverage scarce human resources**

Under this last step, a number of actions were taken to simultaneously change tax policies, strengthen revenue administration, and strengthen expenditure management and control. In some cases, some of these actions were taken at the time that enabling laws were passed (see discussion above).

##### *Policies to mobilize revenues*

Mobilizing domestic revenues presented a difficult challenge in the postconflict era. The task was complicated in some countries where the tax base was limited in the immediate aftermath of the conflict, owing to the destruction and disruption of economic activity. The immediate objective of tax policy in postconflict countries was to raise revenue quickly to finance the most urgent government activities and address macroeconomic imbalances. The longer-term objective was to rehabilitate the tax system, so as to

mobilize revenues sufficient to cover a significant portion of public expenditures. In general, tax policy proposals were consistent with the objective of establishing a fair, transparent, and efficient tax system.<sup>12</sup> However, the strategy for revenue generation had to take into account the state of existing institutions and capacity available to implement policies, as well as tax instruments in place at the time the conflict ended. In addition, there was often a trade-off between short-term revenue mobilization efforts and tax efficiency. In some instances, taxes that were less than desirable from an efficiency point of view were recommended, given the limited options available for generating revenues.

A major challenge for some countries was that a large share of the tax base—in particular, incomes of those working for international institutions—was exempt from income taxation. Many postconflict countries did not impose national income tax on the incomes of expatriates entering the country in connection with relief and reconstruction work. The differential treatment of these expatriates risked the creation of a culture of tax exemptions, and made it more difficult to implement a simple tax system where all taxpayers faced a level playing field.

In existing countries, the approach to revenue mobilization was dictated by the tax system already in place and the administrative and technical capacity available at the time. The approach was to rely as much as possible on the existing system to raise revenues in the short run, and delay major policy initiatives until sufficient capacity had been rebuilt. In some countries, major sources of revenues remained largely unaffected by the conflict or were quickly rehabilitated after the cessation of hostilities. In those countries, greater attention was paid in the early postconflict period on restoring capacity in revenue administration. Tax instruments were left largely intact, except for modifications to make them simpler, more transparent, and easier to implement. Some emphasis was also placed on the collection of arrears; for example, in one country a key IMF recommendation was to accelerate collection of tax arrears from public enterprises, as well as arrears on profit transfers to the budget. Where conflict had so severely damaged capacity that the existing system could not be implemented effectively, the approach was to simplify and streamline the system by reducing the number of taxes, harmonizing rates, and reducing exemptions. In some countries, capacity was so depleted after the conflict that only border taxes provided a significant source of revenue, even though the existing tax system in the country—on paper—was quite satisfactory.

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<sup>12</sup> The objective was to gradually establish a tax system that minimizes distortions and is generally perceived as being fair. To this end, the tax system should (i) minimize interference with individual consumption, saving, investment and production decisions; (ii) be relatively simple, transparent, and rules-based, which facilitates compliance, makes tax administration easier, and reduces corruption; and (iii) be stable and predictable, so that economic agents can avoid the harmful effects of uncertainty.



In most postconflict countries, revenue mobilization relied heavily on indirect taxes. In the initial stages, the emphasis was on international trade taxes (including sales taxes imposed on imports). These were relatively easy to monitor and collect, given that there were only a few border points through which international trade could be conducted. In view of the limited capacity available, the structure of customs tariffs was kept simple, and in some cases consisted of one single rate with limited exemptions. A sales and excise tax on imports was also introduced in some cases, again with a simplified structure. In the initial postconflict period, with limited domestic production, imports accounted for a very high proportion of consumption; as such, a sales tax on imports effectively constituted a domestic consumption tax.

Exchange rate policy also had an impact on revenue collection in postconflict countries that were highly dependent on international trade. In at least one country immediate unification of the official and parallel market exchange rates had a large positive impact on budgetary revenues, since about 60 per cent of total government revenue was derived from a dollar-denominated tax base.

Some countries also introduced a tax on major exports. In cases where one or two products constituted the bulk of the exports whose production was quickly restored following the end of the conflict (e.g., coffee and cashew nuts), an export tax was seen as another area for revenue mobilization in the early postconflict period. From an efficiency standpoint, these taxes leave much to be desired, as they divert resources away from their most productive uses. In addition, by retarding investment in export sectors, these taxes may contribute to future difficulties in the balance of payments. To avoid these distortions, an income tax—including on the incomes of exporters—could be imposed, instead of a tax on exports per se. In some postconflict countries, however, this was not a viable option for raising a large amount of revenue, given the complexity of administering this tax. In this light, a tax on exports was seen as a necessary evil, albeit one that would, over the longer term, be phased out as other sources of revenue became available.

Taxes on selected services with easy tax handles such as restaurants, hotels, and car rentals were recommended. A broader tax on domestically produced goods was considered to be unrealistic in some countries, given the widespread destruction caused by the conflict and limited administrative capacity. At the same time, the large influx of expatriates led to a surge in spending at a small number of hotels and restaurants, providing an easily identifiable tax base that could be exploited in a simple and straightforward manner. The fact that the burden of these taxes would fall on these expatriates also made them politically attractive. In the initial stages, this tax was to be confined to a few large business organizations. As administrative capability developed, the coverage of the tax was intended to be broadened to cover areas such as professional, legal, and accounting services.

In a few countries, changes in administered prices also provided an important source of revenue. For example, domestic market prices of petroleum products were adjusted significantly in order to generate revenue, rationalize the consumption of energy, and discourage smuggling to neighboring countries. This was followed by the introduction of a comprehensive system for taxing energy from domestic sources.

In most countries, some form of income taxation was also proposed. This was deemed necessary for two reasons. First, in some countries, the income tax, in some form or another, existed in the preconflict period. Thus, although the tax was complex to administer, there was previous experience to draw upon while revitalizing this source of revenue. Second, policymakers were concerned that if an income tax of some sort was not introduced from the outset, it would be politically difficult to do so later on. In all cases, the form of taxation proposed had to take into account the available administrative and technical capacity of the country, as well as the loss of some of the tax base owing to the adverse effects of conflict on economic activity and the stock of private sector capital. It was generally recommended that tax rates be harmonized and reduced to encourage compliance, and that the tax base be broadened by limiting exemptions.

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

Measures were also suggested for taxing business income. In the initial stages, a presumptive tax on income was recommended for small businesses. For example, tax assessments would be based on the type of product sold, square footage of the enterprise, or a rough estimate of turnover. While the expected revenue yield from such a tax was not projected to be significant, it was envisaged that in many countries small businesses would quickly become a visibly active part of the economy. As such, there was concern that exempting them from taxation would promote a culture of tax non-compliance. A presumptive tax was considered appropriate at this stage, as small businesses were not expected to be able to maintain reliable accounts, and audit capacity in revenue administration was weak. For large unincorporated businesses, a similar tax was proposed. In one case a minimum business profits tax of between 1 and 2 per cent of the previous year's turnover was proposed—a measure that could be implemented without the passing of a new law.

It was recommended that corporate income taxes be simplified. In some cases, a profit tax existed, but yielded paltry revenues on account of excessively generous tax incentives. In this case, it was suggested that tax incentives be replaced with a simple—and less generous—tax credit for investment in fixed assets. In other cases the recommendation was to replace the progressive corporate tax with a flat income tax on all business income. It was also suggested that investment incentives be streamlined and made more transparent.

#### *Strengthening revenue administration*

In newly created countries, a new revenue administration (tax and customs) needed to be established. In existing countries, depending on the degree of disruption caused by the conflict, some revenue administration capacity was preserved, but it was less effective than before the conflict. Establishing and strengthening revenue administration in postconflict countries generally involved a two-stage process. In the first stage, the priority was to get the tax/customs administrations ‘up and running’. This meant starting revenue collection and registering/controlling the flow of goods across borders—within the twelve months immediately following the end of the conflict. In the second stage—anywhere from twelve to eighteen months after the conflict—the emphasis was on helping countries design, and begin implementing, a medium- to long-term strategy for reforming revenue administration. Such strategies were designed to fit country-specific circumstances and based, as much as possible, on international best practices.

#### *Re-establishing basic tax administration infrastructure*

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

#### *Identifying and appointing key staff*

A key step in getting the revenue administrations up and running was to identify and appoint key staff in senior positions. This was a challenging task in countries without a pre-existing or a seriously impaired national revenue administration following the conflict as there was no pool of experienced government officials to manage and staff the revenue administration. In some cases, at the request of the countries, the IMF’s

technical assistance included identifying a foreign expert who could serve as a ‘shadow’ commissioner. This senior official would take the lead in managing the fledgling revenue administration while working closely with national counterparts to train local staff. The objective was to transfer management responsibilities to local personnel in as short a time as possible.

#### *Registration and taxpayer identification*

In newly formed countries legislation was needed to require individuals or companies engaged in commercial activities to register with the authorities. In countries where a taxpayer register existed this was used as the starting point. In some cases, however, conflict resulted in important changes in the nature and structure of activities of these taxpayers, necessitating a rebuilding of the taxpayer register. Steps were also needed to ensure that all potential new taxpayers were registered. Therefore, registration-check audits were recommended, along with an appropriate penalty regime for non-registrars.

It was also recommended that all registered taxpayers be assigned a unique taxpayer identification number (TIN). This number would be used by taxpayers for filing their taxes (e.g., VAT, corporate income tax). The TIN was expected to (i) effectively identify taxpayers on a nation-wide basis, (ii) assist the revenue administration in crosschecking information on taxpayer compliance, and (iii) at a later stage, facilitate computerization of tax administration.

#### *Establishing basic filing and payment procedures*

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

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

An LTU, focusing on taxpayers accounting for a significant majority (usually 60–80 per cent) of the tax revenues, was recommended for many countries. In the initial phases of the postconflict period, enforcing compliance with basic tax regulations was a major challenge. Scarce administrative capacity could best be used, it was argued, by concentrating on the relatively small number of taxpayers accounting for the lion’s share of tax collections. In the latter phases of the postconflict period, focusing audit

activity on firms monitored by the LTU was seen as more effective in helping raise these taxpayer's compliance (and thus revenue) than more generalized approaches applied to all taxpayers. Moreover, it was also envisaged that setting up LTUs would contribute to longer-term development of tax administration by providing a pilot—with respect to new organizational structure, systems, and procedures (taxpayer registration, filing and payment, audit, enforcement, and taxpayer services)—based on best practices. Setting up the LTUs in a postconflict environment, however, was not an easy task. First, they required a qualified pool of staff who could effectively audit the large taxpayers. This necessitated a higher degree of preparation and training than was often available in postconflict countries. Second, in postconflict countries, the disruption of economic activity during the conflict made it difficult to identify large taxpayers and to assess the impact of the new legislation affecting them.

#### *Re-establishing expenditure management and control*

Upon entering the postconflict era, most countries lacked a well functioning PEM system. The immediate objectives for improving budget management in postconflict environments included (i) restoring control over the expenditure aggregates (fiscal discipline), (ii) ensuring that the budget is spent according to government priorities (improving allocative efficiency), and (iii) giving donors fiduciary assurances that their money is spent in line with what they intend. The last point was particularly important, given that most postconflict countries received a substantial amount of foreign assistance for humanitarian and reconstruction purposes. Thus, accurate and meaningful information on government spending dictated that donor funds should flow through the government expenditure system. However, donors would only agree to this if transparent and accountable procedures for executing public spending were in place. These concerns underscored the need for urgent attention towards improving PEM systems in postconflict countries.

Ensuring that the budget was executed—and not just that total expenditures were under control—was also a central challenge in the postconflict era. In some countries, budgets were not being executed, given the inexperience of the government. This implied that some critical programmes for reconstruction were not being implemented.

Some aspects of the PEM system were accorded greater priority than others in the early postconflict period. Two areas received special attention during this phase: (i) ensuring that the central authority had control over all revenues and expenditures, and (ii) establishing a simple accounting and reporting framework with an appropriate budget classification. In countries where a system was already in place, the approach was to strengthen existing systems. In other countries, the emphasis was on establishing rudimentary systems that were capable of timely and transparent formulation and

reporting of expenditure and revenues at a fairly aggregate level.<sup>13</sup> In some cases, however, the nature of the conflict did not permit the centralization of all revenues and expenditures. In some cases, training was seen as an urgent need in the short run. While training was also envisaged over the long term (see below), in some countries a crash-course of training in basic accounting, financial management, and computer operations was seen as critical for getting the PEM system up and running.

In some countries, a significant portion of revenue and spending was not flowing through the treasury during the conflict period. Thus, government accounts presented only a partial picture of the fiscal situation. With a return to more normal conditions, an attempt was made to reduce fiscal operations conducted through extrabudgetary channels by integrating all government revenues and expenditures into the treasury.<sup>14</sup> Another complicating factor was that in the initial postconflict phase, a large part of both recurrent and capital expenditure was financed by donors. It was advised that all donor funds should flow through the government's PEM system, and that donors avoid establishing competing or conflicting aid disbursement and management mechanisms. At the same time, it was recognized that donors would, in many cases, oppose this recommendation, given their intent to control the outlays they financed.

Improved information on government financial flows was also seen as important for ensuring that all government revenues and spending were captured in a comprehensive fashion. In particular, comprehensive information on government accounts in the banking sector is needed to help ascertain the accuracy of data on fiscal outturns based on accounting data. To improve the quality of financing data and to simplify the process of collecting this information, it was advised that countries implement a Treasury Single Account (TSA). It was envisaged that all government revenues and expenditures would flow through the TSA. The TSA would also allow for better cash management by consolidating cash resources in a single account. In some countries, such an account already existed, but was not comprehensive. In such situations, the approach was to gradually integrate revenue and expenditure flows that were outside of the TSA. In some cases spending agencies held accounts in commercial banks and the approach was to gradually consolidate these accounts in the TSA.<sup>15</sup>

The recommended route for establishing the second objective—a meaningful accounting framework—varied according to country circumstances. In some countries

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<sup>13</sup> In one country, for example, it was recommended that a rudimentary budgetary circular be prepared to provide key assumptions—e.g. on staffing—for spending departments to submit their budget requests.

<sup>14</sup> Lags in fiscal reporting were also a concern, including in the postconflict period. For example, in one country the treasury did not receive any cash transfers from about half of the provincial tax-collecting agencies for a period of over six months.

<sup>15</sup> In one country, for example, there were literally hundreds of different bank accounts.

the existing accounting structure was reasonably compatible with acceptable international standards, and thus the existing system could be used in the initial phases of the postconflict period. However, in others this was not the case, and in newly created countries sometimes no accounting structure existed. There was thus the need to introduce a simple classification system based on administrative units and core functions (e.g., health, education, and security), a few broad economic items (such as wages and salaries, goods and services, and capital expenditures), and a funds/projects classification to facilitate the tracking of funds from different donors. Such a classification provided for streamlining and simplifying budget documentation and thereby promoted fiscal transparency. In addition, a unified reporting format was also developed in these countries to facilitate timely and transparent reporting of fiscal operations, both to the government and donors.

Following the establishment of a basic PEM system, additional steps were recommended to strengthen budget execution. Improved cash flow planning was seen as an essential component in improving budget management. A system to control spending at the commitment stage was also advocated; in cases where commitment control existed, a strengthening of the system was recommended. A basic computerized system to process checks, record information, and produce timely fiscal reports was also suggested in some countries; in others, however, computerization was only viewed as feasible for central offices, with branch offices continuing to use manual procedures.<sup>16</sup>

Further improvements in expenditure procedures were also advocated, but for the latter phases of the reconstruction process. These involved the reinforcement of the administrative and technical capacities of the line ministries and the implementation of more advanced training programmes, usually with donor financing. Other priorities included the drafting of manuals on budget preparation and expenditure authorization procedures. Over time, it was envisaged that a clear set of procedures for the monitoring and control of spending would also be developed and disseminated to all relevant government agencies.

A strengthening of macro-fiscal analysis and audit capacity was also recommended. Setting up a macro-fiscal analysis unit was recommended to provide advice on general fiscal policy issues and the preparation of the budget. More specifically, it would assist the ministry of finance in preparing revenue forecasts for the budget year and fiscal policy scenarios. The timeframe for the establishment of this unit varied depending on country-specific circumstances. At the same time, gradual development and strengthening of auditing capacity, together with the establishment of a code of fiscal

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<sup>16</sup> In most countries, full computerization of the treasury ledger and payments system was viewed as a medium-term (rather than short-term) objective.

conduct, were recommended for limiting corruption, waste, and misappropriation of public resources.

## **5 Summary and conclusions**

It is widely recognized that economic recovery is an essential ingredient for building and sustaining peace in postconflict countries. Macroeconomic conditions in these countries were adverse before conflict began and deteriorated further as a result of it. Real incomes fell during the conflict, fiscal deficits widened, and inflation skyrocketed. Moreover, the composition of spending also worsened due to the conflict. Addressing these macroeconomic imbalances was important for jump-starting the economy and laying the basis for sustained growth.

Economic recovery required supporting institutions and policies, many of which were lacking in postconflict countries. In many countries, institutions were either non-existent when the conflict ended, or were severely damaged by the conflict. Capacity for policy formulation was also often weak. Therefore, establishing and strengthening key institutions was an important early step in many of these countries.

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

Four objectives have guided institution building in the fiscal area: These are (i) avoiding ad hoc decision making; (ii) promoting transparency in fiscal operations; (iii) ensuring a minimum level of revenue collection; and, (iv) ensuring that spending patterns reflected established priorities. A first step was usually to review existing legislation, with a view to simplifying tax laws and administrative procedures or to establish new ones if existing laws and procedures were viewed as inadequate. The next step was to strengthen the central fiscal authority or set one up if none existed. Such an authority usually consisted of four departments: a budget department, a treasury department, and separate departments for tax and customs administration. In some countries, an explicit mechanism for co-ordinating donor assistance was also established.

The IMF's advice was in many ways similar to what it recommends in countries without conflicts, but with important nuances to reflect the realities of postconflict countries. For example, recommendations to introduce simple income taxes based on withholding of wages, to create Large Taxpayer Units, and improve budget classification are frequently recommended in the IMF's advice for developing countries. At the same time, this



advice was tailored to the circumstances of postconflict countries. For example, with respect to tax policy, there was generally more openness to policies that were not first-best from an efficiency point of view (e.g., export taxes), given the urgent need to generate revenue. In a similar vein, proposals to improve tax administration focused on very rudimentary aspects of these procedures (e.g., procedures for filing and payment of taxes and registration checks). Similarly, on the expenditure side, the focus was to implement very simple systems (e.g., budget classifications under very broad categories of outlays) to be improved at a later stage. In some cases, the adoption of the first postconflict budget—sometimes a transitional one—became an urgent priority, unlike in the case of most other countries receiving IMF advice.

The sequencing of reforms was also different for postconflict countries. The timetable for implementing reforms that are part and parcel of a good system of fiscal management—for example, an adequate medium-term expenditure framework—was also much longer. In general, recommendations had to focus on a large number of intermediate measures over the short term that could gradually move budgetary practices from a crisis mode (e.g., where budgets were implemented on a three-month basis) to a more normal state of affairs.

In framing these short-term policies and arrangements, care was taken to ensure that they did not pose an insurmountable obstacle for the eventual transformation to a modern fiscal management system. Looking forward, additional research is needed to ascertain the track record of countries in implementing these recommendations and what progress has been made toward more permanent improvements in the operations of fiscal institutions.

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