

Public Finance in Post-Conflict Statebuilding

A project of the New York University's Center on International Cooperation (CIC)

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Executive Summary

CIC's program on post-conflict statebuilding examines how and why states evolve in post-conflict environments and how international actors can support development of more effective and legitimate states. Public finance – the collection, allocation and expenditure of public resources – is one of the defining functions of a state. In post-conflict circumstances building capacity for public finance faces multiple challenges: states tend to be weak, illegitimate, and unaccountable, societies tend to be polarized with competing informal systems of “taxation”, and much immediate public expenditure is undertaken by international donor agencies rather than the national government.

Public finance “matters” in several ways. Taxes and other revenues finance expenditure and effective expenditures are a precondition for the state ultimately to provide a range of services and public goods. Beyond that, however, citizen willingness to pay taxes is a measure of state *legitimacy*. When citizens pay taxes, they demand better services and *accountability*. Despite the importance of these issues, surprisingly little research has been done specifically on post-conflict public finance. Research that does exist often focuses on the technical dimensions rather than the vital political, economic and social issues in play.

CIC's work seeks to understand state public finance strategies. It will examine the role of international diplomacy, aid conditionality, and technical assistance. Through country case studies to be undertaken in the project's first phase, we will document what has been done successfully and why and what can be learned from mistakes. Drawing on these lessons, the project's second phase will propose solutions to key problems in a series of thematic papers ranging from taxation and customs to aid management and public accountability. Phase One studies will include countries that vary along a number of dimensions, including pre-conflict administrative development, the degree to which government meets the demands of diverse populations, and the extent of reliance on revenues from natural resource extraction. The cases will include a mix of “older” cases, where the implications of early policy choices can be observed, as well as more recent cases where innovative approaches are being tested.

Through a series of ongoing consultations, CIC will link its work closely to issues of concern to policymakers and disseminate its findings widely among them. An Advisory Board including experts from the UN, World Bank, IMF, and key bilateral agencies will reinforce links back into policy. CIC will also tap into the rich experience found in post-conflict countries by inviting former Ministers of Finance and other governmental and non-governmental leaders to join its Advisory Board and to author case studies.

Public Finance in Post-Conflict Statebuilding

Objective and Rationale

Public finance – the collection, allocation and expenditure of public resources – is one of the defining functions of a state. Despite its importance, surprisingly little research has been done specifically on post-conflict public finance and how international actors can better support this core element of statebuilding. Research that does exist often focuses on the technical dimensions rather than the vital political, economic and social issues at stake. Initial discussions with international agencies, the NGO community, and academics working on conflict-affected countries have been universally positive about CIC undertaking serious research in this area.

The Importance of Public Finance to Statebuilding

CIC's program on post-conflict statebuilding examines how governments in a post-war environment can develop core capacities that lay the groundwork for effective and legitimate states. A public finance system is among the most important of those core capacities. The domestic and international political context, however, is often tremendously challenging and can severely undercut the ability of emerging states to improve their ability to manage public resources.

Public finance includes the collection, allocation, and expenditure of public resources by the state and by others. In emerging states, it also includes the actions of international donors, lenders, and implementing agencies (IGOs and NGOs), as well as of military and political groups that may be providing public goods or making use of public resources. There is fierce competition for resources not just between ministries and sub-national entities within the state but also between the state and non-state actors, including NGOs that may receive great attention from international donors, and this presents serious challenges to state revenue generation, resource management and service delivery.

In a consolidated state, revenue collection or generation provides government with the wherewithal to provide services. According to the normative theory of government, these services should constitute impartial public goods such as security, administration, dispute resolution, regulation, human and social capital, and redistributive policies essential for social and economic development. In practice, officials try to use the legitimacy derived from the provision of such public goods as well as asymmetrical access to information to generate surpluses or rents that they can distribute to supporters (patronage) or themselves (corruption) whether through employment, infrastructure, contracts, kickbacks, or downright theft, which detract from the legitimacy of revenue extraction.

In the classical state of theory, taxation falls mainly on the economic activities of citizens, though this varies with the degree of foreign investment. To the extent that governments depend on payments by citizens to finance state activities, the struggle over the extraction and use of these resources becomes a focus of political conflict and legitimation. This struggle can provide the political base for the creation of an effective state that provides

services that are genuinely considered to be public. In many states, however, government revenues are derived from other sources: from rents derived from sales of natural resources extracted by foreign companies; from foreign aid; from loans contracted with international financial institutions, private banks, or bond markets; or by the issuance of currency.

Expenditure management includes both budget allocation and execution. In consolidated states, the budget process is the arena in which resources are allocated to competing priorities, and critical trade-offs are made between political, economic, and social objectives. Sound budget execution or financial management, including procurement, is vital to reduce diversion of public funds and to ensure that resources are used as intended. In weak states, there is no single institutional locus for the political struggle over the allocation of public funds and implementation of public programs. Information about allocation of resources is often closely held, as it has great political value. Accusations, some grounded, of poor financial management by the state, donors and NGOs undermine legitimacy and complicate efforts to collect revenue from citizens, firms and donors. Direct budget support or government-executed “trust funds” are growing but many donors fund each implementing agency separately, leading to a proliferation of program management units each with distinct, donor-mandated operating guidelines and accountability structures. International donors are often exacting in requiring strong and transparent expenditure management and/or policy conditionality, but these create reciprocity and either accountability (or corruption) between government and donors, not between government and society.

Unique Issues in Post-Conflict Public Finance

Post-conflict states face unique challenges in establishing and strengthening public finance systems.

- Post-conflict transitional governments are often contested and may have serious deficits of legitimacy and/or capacities of various types, depending partly on whether the transition is administered by the incumbents, a coalition, former armed opposition, a third-party (technocratic) national transitional government, or an international transitional administration.
- In the course of the war, armed groups, both official and unofficial, are likely to have gained access to taxes, rents, or foreign aid of various kinds to finance their military and political activity and, often, to enrich their key personnel. The peace process (if there is one) typically requires that all armed groups but the government abandon such revenue sources. Incorporating the leaders and reintegrating the followers of such groups are often resource-intensive efforts critical for securing the state’s monopoly on legitimate force and public revenue collection. This may require the formation of new security forces and international peacekeepers or security providers, as well as recruitment of staff of the ministry of finance, also resource-intensive efforts.

- During conflict, armed groups, including those of the state, often benefited from economic activities of varying shades of illegality, such as smuggling and trafficking in gems, timber, drugs, or human beings. Hence post-war economies are likely to have become both criminalized and globalized, making it far more difficult for the government to tax. This ‘grey’ economy also supports competing suppliers of public goods (warlords in rural areas, organized crime in urban areas).
- The international agencies and non-profits that constitute a substantial sector of post-war economic activity are non-taxable and may actually reduce the tax base. In this respect, post-conflict countries are a bit like university towns and have some similar fiscal issues. Societies typically may have to deal with inflationary pressures caused by the influx of expatriates.
- Some post-war states, returning to wartime practices, attempt to compensate for lack of fiscal capacity by printing money (especially when foreign aid is in short supply), leading to hyperinflation. The legacy of hyperinflation, combined with the inflationary effect of the post-conflict foreign presence, requires efforts at monetary stabilization.
- Legacies of distrust and hostility within society undermine the ability of the state to generate consensus around the allocation of scarce public resources. Budget allocation decisions that exacerbate rather than efface horizontal inequalities, be they regional, ethnic, class and religious, deepen factionalism and promote destabilizing “winner-take-all” politics. Control over expenditures can become an inflammatory political issue just when the state most needs to send signals of inclusion. Creating venues where such issues can be aired and resolved publicly is key to binding diverse groups to the new state and establishing state accountability and legitimacy.

In weak states but particularly in post-conflict states where the international presence is often significantly larger, the state, society and international actors bargain and form a triangle of shifting coalitions. The key political dynamic is often derived from the strategic use to which the government or transitional administration tries to put foreign aid: whether to reinforce rent-seeking activities from the conflict period and gain leverage over rivals, or consolidate a state that provides public goods based on law. The interest of foreign donors and the political use they make of their aid also affects the negotiation: some donors may have independent political agendas.

Finally, neither national nor international actors are agnostic about the structure of the state. The neoliberal consensus of donors and IFIs prescribes a small but strong regulatory state, with an open trade regime and investor-friendly policies. These efforts will often conflict with attempts to revert to pre-war practices or to use the state as a center of patronage to buy off a variety of forces that have participated in the war and may threaten recourse to violence again. They also may conflict with state efforts to improve social welfare and address social grievances in ways that build state legitimacy. Public finance systems are being developed while fundamental disagreements may rage

about key conceptions of the state and its role. The long-term developmental and short-run patronage-political approaches to peacemaking may collide with strictures in fiscal and monetary policy. Similarly, conflicts may arise over the extent to which distributional issues (horizontal as well as vertical equity) should be factored into fiscal policies.

Some countries have maneuvered this complex terrain effectively and built some additional capacity to manage public finances, improve transparency and create spaces for state-society deliberation – all of which contribute to statebuilding. Other countries have been less successful and serve as “cautionary tales” that also offer valuable lessons.

Project Design and Activities

CIC’s work on post-conflict public finance will analyze these experiences, examining ways in which the international community has enabled or could support development of sustainable systems for revenue and expenditure management, foster public participation in the oversight of public expenditures, and thereby help generate legitimacy for the institutions created in the peace process. In Phase I, we will analyze retrospectively experiences in this area, primarily by means of country case studies. In Phase II, we will explore innovative policy options, informed by lessons identified in Phase I.

Phase I: We will analyze public finance issues by means of case studies of countries with post-conflict histories that extend back far enough for medium- to long-run fiscal issues to have become visible as well as more recent cases involving nascent but innovative approaches. The case studies will address revenue, expenditure, and implementation issues. In some cases, they may be co-authored to take advantage of different areas of expertise, and to involve both national and expatriate researchers. Potential case studies include Cambodia, Guatemala, Uganda, Eritrea, and the more recent cases of East Timor and Afghanistan. In addition to country case studies on revenue and expenditure issues, a few cross-country studies will examine other public finance-related topics such as debt management and monetary policy.

Specific revenue issues include: the relation of the peace process and transformation of the security sector to the control of revenue sources; the advantages and drawbacks of alternative revenue instruments, such as tariffs, and value-added, income and property taxes in terms of equity (particularly along the axes of past and potential conflict-related cleavages), administrative and political feasibility, and efficiency; examination of why certain policy choices were made over others; efforts to transform illicit or criminalized war economies into taxable economies; and efforts to consolidate revenues and bring them on-budget (including revenues from natural resource extraction and foreign aid). A critical statebuilding challenge on the revenue side is to combine the politics (and economics) of integrating former armed groups with the enhancement of security and government control of revenue. This in turn requires identifying the mix of revenues instruments and sources appropriate for that country’s post-conflict economy, while laying the groundwork for a transition away from dependence on external resource toward greater domestic resource mobilization, binding states and citizens more closely.

Specific expenditure issues include: the role of the state, its citizens, as well as external actors in influencing, understanding and monitoring budget allocation and execution; the reasons why certain policy choices were made over others; the impact of public expenditures on political, economic and social objectives and outcomes; and the degree of transparency in the allocation and management of expenditures. A critical statebuilding challenge is to achieve greater integration between the state operating budget and externally-managed donor expenditures, working initially to align priorities and eventually, to expand state responsibility and accountability for public investment and public services. At the same time, the process of developing state fiscal capacity should be integrated with development of political and social monitoring capacity through parliament, press, NGOs, and other social institutions.

These two sets of issues are interrelated. In a chicken-and-egg fashion, inadequate revenues constrain public expenditure but perceived inequities or deficiencies on the expenditure side, including a pattern of favoring certain groups over others, can constrain public willingness to pay taxes.

CIC has held several planning meetings with key collaborators to develop the research design. The next step is a two-day meeting to be held in New York, with practitioners from conflict-affected countries and from the IFIs, UN and key bilaterals working on public finance to inform CIC’s research design. CIC will organize a first authors’ meeting to ensure commonality of approach, and hold a second authors’ meeting once research is completed to make comparisons and draw conclusions. Key findings and recommendations will be outlined in a CIC policy paper.

Phase II: The second phase will begin, once again, with consultations with policymakers to disseminate the findings of the country case studies, spark discussion, and generate policy consensus around key problems and themes to be addressed in Phase II research. CIC will identify a select set of themes (e.g., innovative tax instruments, expenditure oversight techniques, means to increase public budget deliberation, streamlined aid management, public sector wage strategies), undertaking research to buttress policy recommendations emerging from first-round research and addressing additional topics identified by policymakers and practitioners.

Timetable

Phase I

7-9 March 2005	Project Launch, Phase I Workshop (Advisory Board and authors)
1 June 2005	First drafts of case studies due
19-21 June 2005	Meeting of authors to review first drafts
31 July 2005	Final drafts due
October 2005:	CIC prepares Public Finance Policy Paper, review and comment by Advisory Board
November 2005	Policy Dissemination Meetings to discuss Phase I findings

Phase II

August 2005	Identify topics for thematic studies and solicit comments from Advisory Board
September 2005	Prepare TORs, identify authors and commission studies
January 2006	First drafts of thematic studies due
mid-January 2006	Meeting of authors/Advisory Board to review first drafts
28 February 2006	Final drafts due
30 April 2006	CIC prepares Public Finance Final Report and Recommendations; review and comment by Advisory Board
June 2006	Policy Dissemination Meetings to discuss findings (Phases I/II)

Partnerships and Experience

This work builds on CIC's past work on post-conflict transitions including aid management, humanitarian aid, and security policy.¹ CIC's staff combines academic depth with practical experience in several countries (Afghanistan, East Timor, West Bank/Gaza, Rwanda, Kosovo and El Salvador). CIC will collaborate in this public finance component with the **Political Economy Research Institute at the University of Massachusetts, Amherst**. CIC is convinced that this work could make an important contribution to knowledge and practice in this critical arena of statebuilding.

Lead researcher on the proposed Public Finance Component:

- **James Boyce**, Professor of Economics at the University of Massachusetts at Amherst and director of the Political Economy Research Institute's Program on Development, Peacebuilding, and the Environment

CIC Statebuilding Project Team:

- **Shepard Forman**, Director of the Center on International Cooperation, NYU
- **Bruce Jones**, CIC Deputy Director and currently Deputy Research Director for the Secretary-General's High Level Panel on Threats
- **Barnett Rubin**, CIC Director of Studies, Director of the Afghanistan Reconstruction project
- **Michael Barnett**, Harold Stassen Professor of International Relations, University of Minnesota and Visiting Scholar at CIC
- **Paul Smoke**, Associate Professor of Public Finance and Planning, NYU Robert F. Wagner Graduate School of Public Service
- **Madalene O'Donnell**, CIC "Peacebuilding as Statebuilding" Project Coordinator
- **Laura Sitea**, CIC Research Associate

¹ See Shepard Forman and Stewart Patrick, eds., *Good Intentions: Pledges of Aid in Post-Conflict Societies*, Lynne Rienner Publishers, 2000; Bruce Jones with Feryal Cherif, *Report to DPKO: Evolving Models of Peacekeeping*, January 2004; Barnett Rubin, "Crafting a Constitution for Afghanistan" *Journal of Democracy*, July 2004; Abby Stoddard, "Trends in U.S. Humanitarian Policy" in Macrae J (ed), *The New Humanitarianisms: A Review of Trends in Global Humanitarian Action*, ODI 2002.