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Public Finance, Aid, and Post-Conflict Recovery

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Abstract

In the wake of violent conflict, a key element of building a durable peace is building a state with the ability to collect and manage public resources. To implement peace accords and provide public services, the government must be able to collect revenue, allocate resources, and manage expenditure in a manner that is regarded by its citizens as effective and equitable. This paper addresses eight key issues related to this challenge. The first four pertain to resource mobilization: (i) How should distributional impacts enter into revenue policies? (ii) How can postwar external assistance do more to prime the pump of domestic revenue capacity? (iii) Should macroeconomic strictures prescribed for economic stabilization be relaxed to foster political stabilization? (iv) How should the benefits of external resources be weighed against their costs? The second four issues relate to the expenditure side of public finance: (i) How should the dynamics of conflict be factored into public spending policies? (ii) Can the pathologies of a 'dual public sector' – one funded and managed by the government, the other by the aid donors – be surmounted by channeling external resources through the government, with dual-control oversight mechanisms to reduce corruption? (iii) How should long-term fiscal sustainability enter into short-term expenditure decisions? (iv) Lastly, is there scope for more innovative solutions to postwar legacies of external debts?

Keywords: peacebuilding; revenue mobilization; external assistance; foreign aid; post-conflict transitions; public expenditure; horizontal equity; odious debt.

JEL codes: E61, E62, E63, F35, F51, F53, H20, H22, H50

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Introduction

In the wake of violent conflict, a key element of building a durable peace is building a state with the ability to collect and manage public resources. To implement peace accords and to provide public services, the government must be able to collect revenue, allocate resources, and manage expenditure in a manner that is regarded by its citizens as effective and equitable.

The *Principles for Good International Engagement in Fragile States*, adopted by the development ministers of major donor countries in March 2005, declares that statebuilding is 'the central objective.' This represents a striking break from the prevailing wisdom in the closing decades of the 20^{th} century, when the state was widely regarded as the problem. The state has been rediscovered: it is now invoked as the solution. The policy rhetoric has changed from downsizing states to building state capacity.

Building state capacities in public finance is crucial to the success of peacebuilding efforts for three reasons:

- First, governments must be able to ensure *sustainable funding* for new democratic institutions, for social programs that ease tensions and redress grievances, and for public investments to promote economic growth and development. In the early postwar years, countries often receive a large influx of external assistance that temporarily can meet some of these needs. But aid typically diminishes over time, so domestic resources are necessary to sustain these institutions and programs. A key challenge is to ensure that aid does not 'crowd out' domestic fiscal capacities, but instead stimulates their growth.

- Second, fiscal capacities are needed to build a *legitimate state*. Democratic elections do not, in and of themselves, ensure state legitimacy. Neither do 'quick impact projects' in which international aid agencies seek to fill urgent needs. Legitimacy comes in large part from government delivery of services that people need and want. Elections provide an avenue for the citizenry to voice demands; responding to those demands requires the capacity to mobilize, allocate, and spend public resources effectively.

- Third, in some cases there is a need to curtail extra-legal taxation by 'warlords' and armed groups so as to *enhance security*. In Afghanistan, for example, control of border customs outposts is not only a fiscal issue but also a security issue. Similarly, control over revenues from natural-resource extraction, such as logging in Cambodia or diamonds in West Africa, is often crucial for establishing the state's monopoly not only in legitimate taxation but also in legitimate force. At the same time, domestic fiscal capacity is the only sustainable source of financing for public security after external peacekeepers have withdrawn.

There is a profound interdependence between the state's ability to allocate and manage expenditures and its ability to mobilize domestic resources. On the one hand, the volume of domestic revenue limits the volume of expenditure, a constraint that can be eased but not eliminated by international aid and deficit finance. On the other hand, the willingness of the citizenry to pay taxes hinges on its perception that the state will effectively deliver public goods and services – including infrastructure, public safety, health and education – in return. If the state fails to uphold its end of this social compact, its ability to raise revenue encounters serious political and administrative constraints.

The international community can help to resolve this chicken-and-egg dilemma by providing external resources. In principle, these can fund expenditures that enhance both the ability to pay taxes by stimulating economic recovery and the willingness to pay taxes by demonstrating the state's capacity to deliver results. In practice, however, this positive outcome is not automatic. Budget allocation and expenditure management capacities do not spring forth spontaneously in response to resource availability; they must be built painstakingly over time. The legitimacy of the state rests not only on its ability to provide public goods and services, but also on its willingness to respond to the expressed needs and demands of the public. If external resources fail to build core public finance capacities, and if the state's attentiveness to the preferences of donors deflects it from responding to the needs and demands of its own people, then the long-run contribution of aid to this crucial dimension of statebuilding will prove marginal at best.

In this paper I address eight issues related to the challenges faced by postwar states in strengthening their capacities for more effective public finance, suggesting ways to better fit donor aid to this critical dimension of peacebuilding as statebuilding.

The first four issues pertain to resource mobilization: How should distributional impacts enter into revenue policies? How can postwar external assistance do more to prime the pump of domestic revenue capacity? Should macroeconomic strictures prescribed for economic stabilization be relaxed to foster political stabilization? How should the benefits of external resources be weighed against their costs?

The second four issues relate to the expenditure side of public finance: How should the dynamics of conflict be factored into public spending policies? Can the pathologies of a 'dual public sector' – one funded and managed by the government, the other by the aid donors – be surmounted by channeling external resources through the government, with dual-control oversight mechanisms to reduce corruption? How should long-term fiscal sustainability enter into short-term expenditure decisions? Lastly, is there scope for more innovative solutions to postwar legacies of external debts?

My discussion of these issues draws on the Project on Public Finance in Postconflict Statebuilding, a collaborative research effort hosted by New York University's Center on International Cooperation.[1]

1. Who Pays? Revenue through a conflict lens

The size of government revenue relative to gross domestic product in wartorn societies typically is far below the average for other countries with similar per capita income.[2] At the same time, the needs for government expenditure are, if anything, greater. Hence concerted efforts are needed to increase revenues.

But size is not all that matters. In addition to the total volume of revenue, the distributional impact of revenue collection matters, too. Economists usually think about distribution in terms of 'vertical equity,' differences between rich and poor. But 'horizontal equity' – differences across population groups defined in terms of ethnicity, race, religion, or region – often figures as much (or more) in the dynamics of conflict.

For this reason, in the past decade scholars and policy makers have begun to pay more attention to inter-group disparities. Researchers have analyzed the role of horizontal equity in the genesis of civil wars (Stewart 2000, 2002; Østby 2004). Economists have begun to think hard about how to measure it, starting with spatial inequalities across regions (Stewart *et al.* 2007; Kanbur and Venables 2005). International aid agencies increasingly recognize the need for 'conflict impact assessment' as an input into policy making and project appraisal, and some have begun to put this recognition into practice.[3]

Yet to date, little has been done to bring these insights to bear on revenue policies. The primary revenue goal of postwar government authorities, and of the international agencies that seek to assist them, has been to increase the volume of collections; the secondary goal has been to do so as 'efficiently' as possible. To be sure, increasing the volume of revenue is no small task. And efficiency – if understood in terms of the realities of wartorn societies, as opposed to textbook axioms – is desirable. But neglect of the distributional impacts of taxation can subvert both of these goals.

The starting point for any effort to address this lacuna must be careful documentation of the distributional incidence of revenue instruments, both vertical and horizontal. Collecting the necessary data will be a non-trivial task, for today there is a paucity of such information even in 'normal' developing countries, let alone in wartorn societies.[4] This can be contrasted with the situation in the industrialized countries, where the distributional impacts of proposed taxes typically are subjected to intense scrutiny by politicians and policy makers alike. Ironically, it is precisely where the need for such analysis is greatest – in societies that have embarked on the fragile transition from war to peace – that these issues receive the least attention. Technical assistance from the international community could play a valuable role in filling this information gap.

Documentation is only the first step. The second is to incorporate this information into policy making. In choosing the mix of revenue instruments – the balance between tariffs, value-added taxes and income taxes, for example – their distributional incidence must be considered alongside their revenue potential, administrative feasibility, and efficiency effects. One option that would be likely to receive much more attention, once revenue is seen through the distributional lens, is luxury taxation. Taxes on items such as private automobiles and private aircraft can combine the attractions of administrative ease, distributional progressivity, and substantial revenue. Yet, remarkably, they rarely feature in discussions of postwar revenue policies.

Finally, information on the distributional impacts of revenue instruments, and on the ways that government policies are taking these into account, must be disseminated widely to the public, so as to guard against misperceptions and facilitate compliance by legitimizing the policies. The importance of this was demonstrated vividly in Guatemala, where the peace accords set explicit targets for increasing government revenue and social expenditure. To this end, the first postwar government attempted to increase the tax on large property owners. This effort was scuttled, however, in the face of protests not only from estate owners but also from small-scale indigenous farmers who thought that the tax would burden them (Rodas 2007, p. 90; Jonas 2000, pp. 171-172). The lesson is clear: successful revenue policymaking cannot be a purely technocratic preserve; it must be part and parcel of the democratic process.

2. Priming the Pump? External support for domestic revenue mobilization

Experience has shown that aid can ‘crowd out’ domestic revenue mobilization, reducing the incentive for the government to tax its own populace. If aid instead is to ‘crowd in’ domestic revenue, conscious efforts are needed to this end. The international community can support government efforts to mobilize domestic revenue in four ways: by providing technical assistance; by linking some of its aid to progress in domestic revenue performance; by helping to curb extra-legal revenue exactions; and by reducing tax exemptions on postwar aid.

(i) *Technical assistance* (TA) is the most common type of support. In public finance, as in other arenas, the effectiveness of TA could be strengthened by efforts to adopt technologies and procedures that build on existing capacities, rather than opting for off-the-shelf imported solutions. In Afghanistan, for example, Ghani *et al.* (2007, p. 167) report that computerized information systems introduced at the Ministry of Finance were ‘unsuitable in terms of complexity and language,’ prompting subsequent efforts to retool with Persian-language systems from Iran.

There is also scope for greater conflict sensitivity in technical assistance. In some cases, TA providers have shown an impressive ability to cast aside orthodoxies and adapt their policy advice to local realities. For example, despite the aversion of the international financial institutions (IFIs) to trade taxes, import duties were recognized as the most feasible source of revenue enhancement in Timor-Leste, Kosovo, and Afghanistan. In the case of Timor-Leste, the IMF even supported the introduction of a levy on coffee exports (Pires and Francino 2007, p. 131), a policy that verges on the heretical. In other cases, however, orthodoxy has triumphed over pragmatism. In Guatemala, for example, even as the IMF gave rhetorical support to the goal of revenue enhancement mandated by the peace accords, the Fund’s staff urged the government to cut tariffs.[5] Theoretical work and empirical evidence cast doubt on both the efficiency advantages of a shift from tariffs to value-added taxes and the prospects for accomplishing this without a decline in total revenues.[6] Nevertheless, this remains a key plank of IFI policy prescriptions in developing countries. In postwar countries, where administrative capacities are especially weak and the need for revenue especially pressing, the case for departures from orthodoxy is all the more compelling.

(ii) *Conditionality* is a second way that donors can encourage domestic resource mobilization. On the expenditure side of fiscal policy, it is not unusual for donors to require ‘counterpart funding’ by the government as a condition for aid to specific projects, a strategy intended to ensure domestic ‘buy-in’ and to counteract fungibility (whereby aid merely frees government money for other uses). But on the revenue side, conditionality of this type has been rare. It would be a straightforward matter to link certain types of aid – notably budget support – to progress in meeting domestic revenue targets. Such a policy is akin to the provision of ‘matching grants’ by private foundations. In both cases, the aim is to strengthen incentives for aid recipients to seek further resources, counteracting the disincentive effects of unconditional aid.[7]

Visiting Guatemala in May 1997, a few months after the signing of that country’s peace accords, IMF Managing Director Michel Camdessus took a broad step in this direction when he stated that the Fund’s only condition for a stand-by agreement would be that the government comply with its peace-accord commitments, including a 50% increase in the revenue-to-GDP ratio.[8] Making a tighter linkage, the European Union made its budget support to the government of Mozambique in 2002 conditional on increases in domestic revenue.[9] One of the benchmarks in the Afghanistan Compact signed in London in early

2006, which sets out the framework for international assistance to that country over the next five years, is to increase the revenue/GDP ratio from 4.5% in 2004/05 to 8% in 2010/11.[10] But conditionality with respect to revenue mobilization remains the exception, not the rule.

One way to implement revenue conditionality would be for donors to enter into a multi-year compact to provide matching funds for direct budget support. Donors could agree to match a percentage of the funds collected by the host government up to a fixed limit. The percentage could be reduced over time, reflecting the increasing capacity of the host government to raise revenue, and the expected increase in economic activity and therefore the tax base. The simplest system would involve monthly certification of the changes in the balance of the Ministry of Finance general revenue account at the Central Bank by an independent authority, and based on these changes, automatic disbursements from the trust fund into the revenue account (Carnahan 2007).

(iii) *Curbing extra-legal revenue exactions* in some cases is a critical postwar task, one that is located on the cusp between public finance and security. When profits from the exploitation of nominally public resources, like Cambodia's forests, flow into private pockets, this not only deprives the state of revenues but also often finances quasi-autonomous armed groups that threaten the peace (Le Billon 2000). When local warlords levy 'taxes' on trade, sometimes including trade in narcotics, as in Afghanistan, they undermine the state's monopoly not only in revenue collection but also in the legitimate exercise of force. Curtailing such activities may require the assistance of international peacekeeping forces, which is what prompted the Afghan finance ministry's request for help in securing customs posts (Ghani *et al.* 2007, p. 170). Yet peacekeeping forces, even those with a relatively expansive mandate like the International Security Assistance Force (ISAF) in Afghanistan, typically have not seen this as a part of their job.

Even more problematic, powerful members of the international community may be reluctant to crack down on extra-legal revenue exactions when they regard those involved as political allies. In Afghanistan, for example, efforts to consolidate revenue in the hands of the state and to fight drug trafficking have been complicated – to put it lightly – by the decision of the United States government to enlist anti-Taliban warlords as partners in its 'global war on terror.' Such marriages of convenience, reminiscent of U.S. support to the anti-Soviet *mujahadeen* in the 1980s, may serve short-run security objectives, but do so only at the expense of undermining the legitimacy and effectiveness of the state – and ultimately security too – in the long run.[11]

(iv) *Reducing tax exemptions on postwar aid flows* could do a great deal to prime the pump of domestic revenue-collection capacity. In the early postwar years, aid is often the single biggest component of the formal-sector economy. Yet today aid flows, and the incomes generated by them, are largely exempt from taxation by the governments of aid-receiving countries. The incomes of expatriate aid officials and aid workers are tax-exempt. The incomes of the local staff of aid agencies, frequently quite high by local standards, are often tax-free too. The goods imported by the aid agencies, ranging from Toyota land cruisers to cases of Coca-Cola and whiskey, often enter the country dutyfree. The rents paid by expatriates for office space and housing – again, often exorbitant by local standards – are frequently tax-free. So are other services provided to them, such as hotels and restaurants.

These pervasive exemptions have several adverse consequences. Most obvious is the opportunity cost of foregone government revenues. In addition, scarce administrative capacity is devoted to administering different rules for different people. Goods that enter the country as aid frequently wind up on sale in local markets, undercutting legitimate competitors who pay import duties.[12] Last but not least, the special treatment accorded to expatriates sends an unmistakable message to the local populace: rich and powerful people do not have to pay taxes. The result can be 'the creation of a culture of tax exemptions,' in the words of a recent IMF review of post-conflict experiences (Gupta *et al.* 2005, p. 12). This demonstration effect runs precisely counter to efforts to establish effective and progressive revenue collection systems. It also undermines the credibility of international agencies when they argue, as in Cambodia, that governments should reduce tax loopholes and 'tax incentives' for local businesses (Smoke and Taliercio 2007, p. 82).

Efforts to tax aid bonanzas – even with backing from the IMF – have run into adamant resistance from aid donors. In Timor-Leste, efforts to tax the floating hotels in the Dili harbor that accommodated the postwar influx of foreigners were rebuffed by lawyers at United Nations headquarters in New York, on the dubious grounds that diplomatic 'privileges and immunities' extend to those who provide services to UN personnel (Pires and Francino 2007, p. 135). In Afghanistan, the introduction of a tax on rental incomes generated by expatriates in Kabul likewise met resistance (Carnahan 2007, p. 9). As Ghani *et al.* (2007, p. 174) remark, 'the international community's declarations on the importance of enhancing domestic revenue mobilization have not been matched by willingness to consider new initiatives to tap the revenue possibilities generated by their own presence.'

This issue has often pitted the IMF and World Bank, along with national officials, against other donor agencies. In the case of Timor-Leste, Pires and Francino (2007, p. 136) recall 'bitter fights between international officials at the Ministry of Finance and international officials of donor organizations … with the latter winning.' The finance ministry's inability to tax the international presence where there was not an explicit legal basis for their exemption came as a 'bitter blow': 'Generally the donors and the UN, who disagreed about many things, were as one on their inviolable right to a complete exemption from taxes, not only for themselves as individuals or for goods imported for their direct use, but also on their contractors and goods imported for reconstruction.'

As Pries and Francino (2007, p. 136) explain, donor agency staff made three arguments against paying taxes. The first was that this would be equivalent to budget support. This is true. But its implicit premise – that the government cannot be trusted to use tax revenues well – again sends a clear message to the local populace. The second argument was that expatriates were already paying taxes in their countries of origin. In cases where this is so, existing tax treaties allow credits for taxes paid elsewhere, avoiding the problem of double taxation. The third argument was that no other countries where they worked had taxed them, ‘so why should East Timor be any different?’ The answer to this objection is, of course, that desirable changes have to begin somewhere.

Under the Convention on the Privileges and Immunities of the United Nations, UN officials are ‘exempt from taxation on the salaries and emoluments paid to them by the United Nations’ (United Nations 1946, sec. 18b).[13] Most bilateral aid agreements today include a clause that grants the donor agencies privileges and immunities that are ‘no less than’ those enjoyed by the United Nations (Carnahan 2007, p. 7). Although the Convention makes no mention of local staff or contractors, over time its tax exemptions often have been construed to cover them, too.

There are good reasons to revisit and reinterpret the Convention on the Privileges and Immunities regarding the extent of exemptions for United Nations missions and, by extension, bilateral missions, international agencies, and international and local contractors from local taxes, fees, and user charges. As Carnahan (2007, p. 10) observes, ‘The Convention was crafted 60 years ago in a very different environment from that in which the United Nations now operates. Today there are many more peacekeeping missions … and peacekeeping missions have become more complex involving a broader array of activities.’ A meeting to consider the taxation treatment of the international community could be convened under the auspices of the OECD’s Development Assistance Committee (DAC), the new UN Peacebuilding Commission, or the IMF.

Initiatives could also be taken by individual donor countries acting unilaterally, in the form of ‘payments in lieu of taxes’ (PILOTs). This solution has been adopted in a number of college towns in the U.S., where municipal governments quite understandably want tax-exempt institutions of higher education to contribute to funding public schools, police and fire protection, and other local services. Negotiated PILOTs maintain the legal privileges of those who make the payments, and open the door for those donors who are serious about building domestic revenue capacity to act without waiting for across-the-board solutions.

If such agreements were to include income tax payments by expatriate or local aid personnel, these need not come from the own pockets of the individuals covered. Those who pay taxes could be given salary ‘top-ups’ to maintain their after-tax incomes, just as US citizens employed by the United Nations system, including the World Bank and IMF, now receive pay increments to compensate for the fact that they must pay US income taxes.

3. Economic versus Political Stabilization? Balancing the budget deficit

An alternative way that governments can mobilize domestic resources – apart from increasing revenues – is to borrow or print money to cover budget deficits. In many postwar settings, a lack of well-developed financial markets means that domestic borrowing is not feasible. Even where this is possible, governments may be reluctant to borrow since this could push up interest rates and dampen private investment.

Printing money can be a more tempting option. This does not require the institutional capacities for a market in government bonds. Instead the government ‘borrows’ from its own central bank. But this type of deficit finance has costs, too. If printing money fuels rapid inflation, this can disrupt the economy, hit the real incomes of the poor (who generally are least able to ‘index’ their incomes to prices), and spark political unrest.

For these reasons, many economists advocate tight restrictions on budget deficits in general, and restrictions on Central Bank financing of them in particular. One need not be a monetarist economist to appreciate the merits of this position. Yet controlling inflation is not the sole objective of economic policy. In settings with widespread unemployment (or underemployment) and slack demand, modest inflation may be a tolerable price to pay for gains in employment and growth.[14] The conventional economic wisdom today holds that inflation cannot boost employment in the long run. In the short run, however, there is no doubt that inflationary finance can provide an economic stimulus.

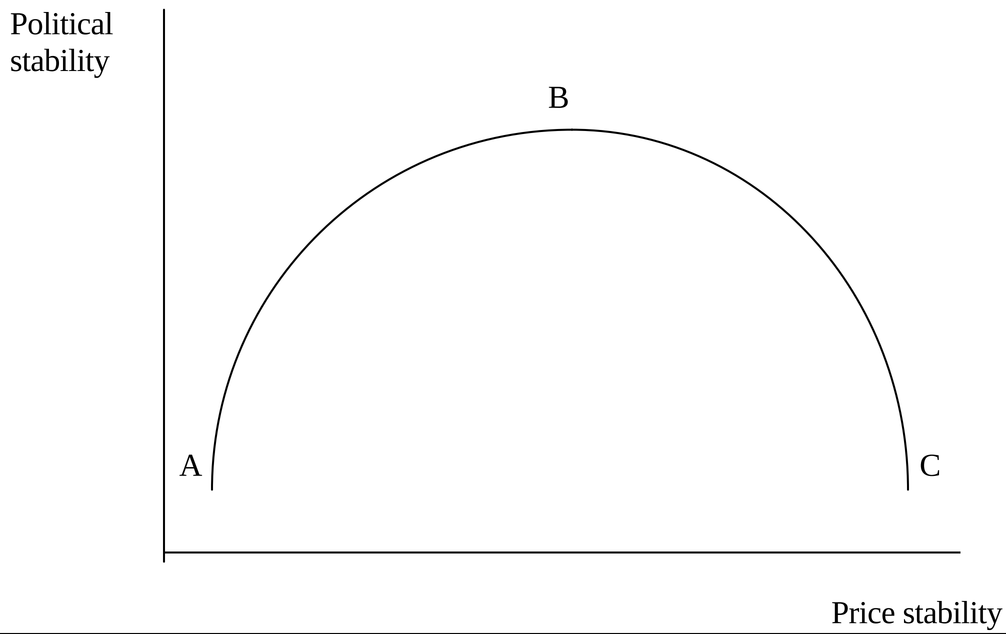
In postwar countries, short-run concerns have special salience. The macroeconomic goal of price stability must be pursued alongside the peacebuilding goal of political stability. The former requires efforts to balance the budget, or at least to rein in the gap between expenditure and revenue. But the latter may require expenditures to implement peace-accord commitments and to address pressing social needs that surpass the resources available to the government. In such settings, the need for a balanced budget itself must be balanced against the urgent need for peace-related spending.

When confronted with the argument that relaxation of price-stability targets could increase political stability by allowing more expenditures to ease social tensions, proponents of 'sound money' counter that price instability fuels social tensions, too. Both sides may be right. Beyond some point, high inflation – and certainly 'hyperinflation' at rates above 50% per month – would harm the economy in general and the poor in particular, exacerbating tensions. At the same time, however, excessively tight money and a complete refusal to finance budget deficits via the 'inflation tax' could impede efforts to fund peace-related needs.

If so, the relationship between the macroeconomic stability and political stability may take the shape of an inverted 'U', rather than a straight line. This is depicted in Figure 1. The horizontal axis represents price stability, with movement away from the origin denoting lower inflation. The vertical axis represents political stability, with movement away from the origin denoting lower social tensions. Supporters of stringent anti-inflation policies assume that the country is on the upward-sloping part of the curve, segment *AB*, where greater macroeconomic stability fosters greater political stability. In asserting that there is a tradeoff between the two, critics of these policies assume that the country is on the downward-sloping segment, *BC.*

Both scenarios are plausible. Research at the interface between macroeconomics and conflict impact assessment is needed to estimate where the turning point is located in any given time and place. Equally important is to explore policies that might shift the curve, easing potential tradeoffs between macroeconomic and political stability. If, for example, there is scope for shifting public expenditure from items that do little to consolidate peace to other uses that are central to this goal, this would help to reconcile the two stability objectives.

Figure 1: Price stability and political stability



Even though some relaxation of budget-deficit targets may be warranted to advance the goal of political stabilization, the scope for financing public spending by this route is limited: at some point, price instability will feed into political instability. Printing money may increase the government's room for maneuver at the margin, but it is not a 'soft' substitute for domestic revenue mobilization. As Coats (2007, p. 215) remarks, 'the possibility of central bank lending to the government historically has often proven an irresistible temptation.' Opening the door a crack can let in flood of inflationary finance. Moreover there are some cases in which very strict monetary policies – or even a straightjacket on the central bank's ability to print money, in the form of 'dollarization' or a currency board – can enhance political stability, by taking a bone of contention off the table. Coats (2007) argues that was the case in Bosnia, where a currency board arrangement was mandated in the Dayton peace agreement. There may be good arguments for recalibrating monetary discipline in light of the political demands of war-to-peace transitions, but there is no good argument for abandoning it.

4. How Much Aid? Dilemmas in external resource mobilization

Government expenditures can be funded by *external* resources as well as by domestic resources – that is, by grants and loans from overseas. In postwar countries, these external resources come mostly from official aid donors: the Bretton Woods institutions, the regional development banks, and bilateral aid agencies.

For recipients, aid has both benefits and costs. External budget support allows a government to spend money – for example, to pay teachers, healthcare workers, and public security forces – beyond the constraints otherwise imposed by its capacity to mobilize domestic resources. This buys time for the government to increase domestic revenues. The costs to the recipient country include the risk that external resources will crowd out domestic resource mobilization; the risk that external resources will lead to unsustainable expenditure commitments; and the risks posed by exchange-rate appreciation and policies to counter it.

When a government's popularity among aid donors enables it to attract substantial budget support, the IMF sometimes presses for ceilings on the 'domestic primary deficit,' the extent to which the government uses aid to finance public expenditure. These ceilings are intended to contain the potential adverse macroeconomic effects of aid inflows. The logic is that foreign currency inflows from aid can lead to exchange-rate appreciation, making the country's tradable-goods sector (exports and import substitutes) less competitive, a phenomenon akin to the 'Dutch disease' in which a boom in natural-resource exports has the same effect. If the Central Bank increases the money supply to counter upward pressure on the exchange rate, this can lead to inflation. If the Central Bank issues bonds to absorb the increased money supply and control inflation (a policy mix known as 'sterilization'), this can push up domestic interest rates, adversely affecting private investment. Faced with the tradeoffs among exchange-rate appreciation, inflation, and higher interest rates, aid ceilings represent a policy for damage control.

To control the domestic primary deficit in Uganda, for example, the government imposes limits on the share of expenditure in each ministry that can be financed by external resources. As Ndikumana and Nannyonjo (2007, p. 47) these aid-intensity ceilings inflict yet another kind of damage, constraining expenditures that could improve social welfare. Uganda's health targets go unmet even as unemployed doctors and nurses emigrate abroad in search of work.[15] When a country has unemployed resources that can be put to work with aid financing – as appears to the case in this instance – the very elastic supply response means that the impacts of greater aid absorption on inflation and the exchange rate would likely be modest.[16] Moreover, Ndikumana and Nannyonjo (2007, pp. 46-47) argue that aid-intensity ceilings fail to take due account of the fact that much aid is spent abroad on goods and services that do not compete with local production – for example, on technical assistance salaries that are deposited directly into foreign bank accounts. Since such aid does not pose sterilization dilemmas, there is no reason to include it in the calculation of expenditure ceilings.

A recent IMF study echoes these concerns. Instead of real exchange-rate appreciation as aid flows surged, Uganda actually experienced depreciation and low inflation, a scenario that suggests ‘a rapid supply response to aid expenditures or high import propensities’ as well as fiscal and monetary policies designed to counter appreciation (IMF 2005, p. 13). ‘Concerns about inflation,’ the study cautions, ‘must be balanced against the dangers of failing to absorb the aid and of crowding out the private sector’ (IMF 2005, p. 5).[17]

Of course, there may be other good reasons for aid-intensity ceilings, apart from macroeconomic concerns. ‘Plentiful aid,’ Bevan (2005, p. 4) observes, ‘may induce corruption and other rent-seeking activities in much the same way that resource rents have frequently done.’ Plentiful aid can lure governments into unsustainable expenditure commitments, a problem discussed below. Plentiful aid can undermine sovereignty: ‘Countries whose budgets rely heavily on aid flows rather than on their own domestic resources,’ Heller (2005, p. 22) observes, ‘give up significant political autonomy in their capacity to manage and make decisions on budget priorities.' Plentiful aid also can undermine democracy, diminishing political accountability to the local populace and tilting the state's attention instead to accountability to donors. And capping the ratio of external resources to total expenditures strengthens incentives for domestic resource mobilization.

Taking into account these costs of aid, as well as its benefits, policy makers again may face an 'inverted-U' curve, with aid intensity on the horizontal axis and aid's contribution to the goals of statebuilding and peacebuilding on the vertical axis: aid may advance these goals up to a point, after which its marginal impact turns negative. If so, again there is a need to analyze where this turning point is located in specific times and places, and what can be done to shift the curve by enhancing the positive effects of aid and countering its negative effects.

Donor agencies, operating within an overall budget envelope, also face an opportunity cost: aid provided to one country cannot be provided to another. In recent years, donors increasingly have adopted country assessment tools in an effort to channel aid to those countries where it will have the greatest positive impact. The World Bank, for example, uses Country Policy and Institutional Assessment scores in allocating aid (World Bank 2005c). The European Union uses results-based performance indicators, such as vaccination and school enrollment rates, to guide its budget support to developing countries (European Commission 2005). This move towards selectivity has led to a bifurcation between 'aid darlings' and 'aid orphans' – governments that score well in such assessments and those that score poorly (World Bank and IMF 2005, p. 17) Wartorn countries are often in the latter camp.

Two innovations could make selective aid allocations better attuned to the requirements of postwar statebuilding. The first is the incorporation of trends, as well as levels, into existing performance indicators.[18] The second is the development of new indicators that assess progress in conflict resolution and peacebuilding. The latter would apply conflict assessment to the allocation of aid *among* countries as well as within them.

5. Who Benefits? Expenditure through a conflict lens

Turning to the expenditure side of public finance, policy making in postwar settings requires careful attention to questions of *to whom* and well as *what.*

The 'what' question is about priorities. Faced with many pressing needs – for spending in areas such as public safety, the demobilization and reintegration of ex-combatants, health, education, and the rehabilitation of economic infrastructure – how should scarce resources best be allocated? The key point here is that the aim must be not simply to maximize returns defined in terms of conventional development indicators, but also to get the most 'non-bang for the buck' in terms of building a durable peace.

Making the same point, the synthesis report emerging from the World Bank's research program on violent conflict observes that this 'creates the potential for trade-offs between policies that promote growth and those that promote peace' (Collier *et al.* 2003, p. 166). In particular, a strategy focused exclusively on short-term economic returns might concentrate spending on the capital city and developed regions of the country, leading to 'a trade-off between the growth-maximizing geographic distribution of public expenditure and a distribution that might be regarded as fair.' Where such trade-offs exist, the report concludes, 'the government may need to give priority to policies for peace building.'

When viewed through a conflict lens, the 'what' question in public expenditure cannot be divorced from the 'to whom' question. Two sets of issues are particularly relevant. The first is how to incorporate vertical and horizontal equity concerns into spending decisions. The second is how to allocate expenditures across the political landscape so as to bolster incentives for the implementation of accords and the consolidation of peace.

Conflict impact assessments could address both sets of issues. These are analogous to environmental impact assessments, first introduced in the 1970s, with the difference that here the concern is the social and political environment rather than the natural environment. Just as environmental impact assessment aims to incorporate 'negative externalities' of pollution and natural resource depletion into expenditure policies, so conflict impact assessment aims to incorporate the 'negative externalities' of social tensions and violent conflict.

Today, efforts to incorporate equity impacts into expenditure decisions are still in their infancy. Information on vertical equity – the distribution of benefits across the poor-to-rich spectrum – is sometimes collected and sometimes used as an input into policy making. In many cases, however, even such basic data are not available.

In the case of horizontal equity – distribution across regions and groups defined on the basis of race, ethnicity, language, or religion – the current lack of information is even more glaring. Collection of regional data on expenditures in administrative units, such as states, provinces, and districts, would seem to be relatively straightforward, both practically (since ministries often allocate their funds across regional units) and politically (since regions often can serve as a proxy for more sensitive categories such as ethnicity). Yet today such data are remarkably few and far between. Afghanistan's former finance minister and his colleagues recount their experience:

> *Obtaining the figures on provincial expenditures from line ministries required months of intense discussion and analysis of manual systems of recordings. When the figures were first presented to the Cabinet, it came as a shock that the ten poorest provinces of the country were receiving the smallest amounts of allocation.* (Ghani *et al*. 2007, p. 179).

The most unusual feature of this experience is that the finance ministry went to the trouble to request this information. Faced with such paucity of data, conflict impact assessment today is roughly where environmental impact assessment was three decades ago. But the search for new analytical tools has begun.[19]

In addition to equity, postwar expenditure policy must consider balances of power among and within competing parties. This requires attention not only to community-wide characteristics such as living standards and ethnicity, but also to the stances of individual political leaders who often vary in their commitment to peace. Some leaders are enthusiastic about implementing peace agreements, others are lukewarm, and still others are prepared to resume war rather than make concessions for peace. Selective allocation of public spending can be one instrument to reward those who are committed to peace, penalize spoilers, and encourage vacillators to get off the fence on the side of peace implementation.[20] If, however, public spending instead strengthens the hand of hardliners, this can contribute to an unraveling of the peace process.

Systematic attention to this dimension of the ‘to whom’ question is rare. One exception is the selective allocation of aid to municipalities in Bosnia and Hercegovina, taking into account the stance of local authorities regarding implementation of the Dayton Peace Agreement’s key provisions. The ‘open cities’ program of the United Nations High Commission for Refugees, for example, targeted reconstruction assistance to municipalities whose officials agreed to welcome the return of refugees and internally displaced persons. Similarly, the World Bank sought advice from the Office of the High Representative in allocating aid for rehabilitation of municipal infrastructure.[21] To date, however, such conflict sensitivity in expenditure decisions remains the exception rather than the rule.

6. Dual Public Sector or Dual Control? External support for domestic expenditure

The international community often seeks to help postwar governments to develop fiscal capacity to allocate and manage expenditure by providing technical assistance. More could be done, however, if donors were to channel a greater share of their resources through the state rather than bypassing it. This will require new strategies for combating corruption and ensuring fiduciary responsibility.

Beyond the 'dual public sector'

The current practice of routing the lion's share of external assistance outside the government gives rise to a 'dual public sector': an internal public sector that is funded and managed by the government, and an external public sector that is funded and managed by the donors. In sheer money terms, the latter frequently dwarfs the former.

The dual public sector phenomenon has several adverse consequences. Most evident is the opportunity cost of failing to tap these resources to build state capacities to allocate and manage public expenditure. Less obvious, but no less serious, is the 'crowding-out' effect as professionals are recruited into the external public sector, often at salaries that the government cannot match.

The fact that the external public sector is managed by numerous agencies, each with their own priorities, also poses enormous coordination problems. This also leads to the waste of scarce administrative resources, as government ministries cope with the different reporting systems of multiple funders. Last but not least, there are no institutional mechanisms that make donor agencies accountable to the local citizenry. No matter how imperfect the degree of democratic governance, the state arguably has a comparative advantage in this respect.

When pressed on this issue, donors maintain that they (and the non-governmental organizations and private contractors on whom they often rely) do a more effective job than the government in delivering goods and services. This is not an argument that can be dismissed lightly. There undoubtedly are situations in which the short-run advantages of circumventing the state are compelling. But once we recognize that the long-run aim of aid is – or ought to be – to *build state capacities* as well as to deliver services, the argument loses at least some of its force.

Experience shows that the ‘short run’ can last a long time. In Cambodia, where more than a decade has elapsed since the United Nations transitional administration handed power to a new government, spending on technical assistance remains two to three times greater than the total wages paid to government civil servants (Smoke and Taliercio 2007, p. 81).

The Afghanistan Reconstruction Trust Fund (ARTF) offers an instructive model for how donors can route aid through the government – in effect, helping to internalize external resources. The ARTF is a World Bank-administered account through which donors help to fund the government's recurrent budget. The government allocates these external resources through its internal budgetary process, reinforcing the budget as the central instrument of policy. When the ministries spend the money – for example, paying teachers – an external monitoring agent appointed by the World Bank verifies that the accounting standards of the ARTF and government (which are the same) have been met, and releases the funds. The ARTF thus is like a bank account with a fiduciary screen. Approximately two-thirds of the Afghan government's non-security recurrent budget is now being funded by the ARTF, although this amount remains small relative to total external assistance.[22]

Channeling aid through the government in this fashion does not imply that the donors abdicate control or responsibility for how their resources are used. The ARTF does not issue blank checks. Two signatures are required to release funds, one from the government and one from the external monitoring agent. The result is a dual-control system – a setup analogous to the dual-key system used to prevent an accidental launch of nuclear missiles.

Combating corruption

Corruption saps the delivery of public services, deters private investment, and fuels popular discontent.[23] But efforts to combat it are complicated where corruption helps to maintain political cohesion by distributing resources through informal channels. Not all corruption is equally corrupt, or equally corrosive: in some cases it is driven entirely by individual greed, but in others it provides patronage resources for wider networks. An example of the latter is the use of government revenues and profits from state-sanctioned monopolies to lubricate ‘neopatrimonial’ governance in the Palestinian Authority under Yasir Arafat (see Brynen 2007).

Donors often adopt an ‘avoidance strategy’ for dealing with corruption: avoid ‘leakages’ by bypassing the government, and avoid public discussion of the topic for fear of ruffling political feathers. This strategy is dysfunctional for two reasons. First, aid that is routed outside the government is not insulated from either the perception or the reality of corruption.[24] Indeed, the lack of transparency and accountability mechanisms can fuel public perceptions that externally administered projects are even more prone to corruption than government projects.[25]

Second, the avoidance strategy fails to harness aid to build the state’s capacity to budget and manage public expenditure effectively. And just as the refusal of the donor agencies to pay taxes has a demonstration effect – sending a message to the populace of no confidence in the government – so, too, their refusal to route resources through the government sends an unmistakable signal.

An alternative strategy for addressing problems of corruption would have two prongs. The first is the use of dual-control systems, like the ARTF, to build more robust institutions for accountability and transparency along with public expenditure capacities.[26] The second is to devise transitional adjustment assistance programs for people who have been dependent on patronage networks, recognizing that corruption for this purpose differs from personal corruption. Such assistance would be analogous, in a sense, to job training programs for workers displaced by the effects of trade liberalization in industrialized countries, and – closer to home – to the disarmament, demobilization, and reintegration (DDR) programs for ex-combatants that are often implemented in postwar countries.

7. Thinking about Tomorrow, Today? Getting serious about fiscal sustainability

External resources that are spent today – whether channeled through the state or around it – often have consequences for how domestic resources must be spent tomorrow. This is true both for recurrent expenditures, like salaries, and for capital expenditures that will require spending for operation and maintenance in future years. Hence there is a need to think about the long-term fiscal implications of current decisions.

In the aftermath of war, attention to pressing short-term needs is perfectly natural, and perfectly valid. But this does not imply that the future consequences of today's decisions can or should be shunted aside for others to handle later. The long run begins in the short run. Myopia not only postpones getting serious about long-run problems, but also can make them worse.

Although much can be done to enhance domestic revenue capacities, the sky is not the limit. Prudence demands recognition that budget constraints will always be a fact of life. In building new government institutions and infrastructure, this reality must be borne in mind. It would be a mistake to rely on a transitory flush of external funds to create structures that are not fiscally sustainable. The point may seem obvious, but past experience suggests that it is often ignored.

Consider, for example, security spending in Afghanistan, where the Afghan National Army has been built with large-scale funding from the United States government. Security-sector expenditures in the three-year period from 2003/04 to 2005/06 were equivalent to 494% of the Afghan government's revenue, or roughly one-third of the country's GDP.[27] 'Total security expenditures will exceed forecast domestic revenues for some years to come,' warns a recent World Bank study (2005a, p. 47) that describes the situation as 'unaffordable and fiscally unsustainable.'

As Ghani *et al.* (2007, p. 182) remark, 'Even under very optimistic projections for domestic revenue, such an expenditure on security would imply a totally inadequate allocation of resources for human capital, infrastructure, and other vital functions of government.' Even from a security standpoint, unsustainable expenditures are shortsighted. A well-equipped army that isn't getting paid ceases to be a security force. Instead it becomes an insecurity force.

A recent operational note prepared jointly by the United Nations Development Group and the World Bank (2005, p 4) draws the clear lesson from such experiences: 'It is important to ensure that security issues are treated as an integral part of the national planning and budgetary process, rather than through separate fora which may lead to a lack of transparency or the taking of decisions which are fiscally unsustainable or undermine other reconstruction efforts.'

The problem of unsustainable expenditure is not confined to the security sector. Salary supplements for civil servants – including 'sitting fees' for attending donor-funded workshops, where 'the daily rates can exceed regular monthly salaries' (Moss *et al.* 2005, p. 7) – likewise can create problems for fiscal sustainability. Citing studies showing that additional remuneration to civil servants in Cambodia far exceeds their regular salaries, a recent UNDP study concludes that 'the principal incentive to work in public employment is the prospect of access to external salary supplements' (Beresford *et al.* 2004, p. 33).

Capital investments with high operation and maintenance costs also generate fiscal burdens down the road. In Palestine, Brynen (2007, p. 199) reports, aid donors have often ignored the development plans of the Palestinian Authority (PA), 'undercutting any PA effort to monitor the cumulative long-term costs of donor-financed investments.' Again he points to the resulting distortion in incentives: the 'lure of donor money' encouraged government officials to put forward projects 'not because they were a real priority, but because they seemed most likely to attract some external funding.'

A famous example of a costly, donor-driven project with high 'flagpole value' but problematic fiscal implications is the Gaza hospital financed by the European Union (Brynen 2000, pp. 196-197). 'Donor-driven investments in public hospitals are sometimes referred to as "Trojan horses",' notes a recent World Bank report (2005b, p 52), 'because of their large operating costs which crowd resources out of priority areas such as the basic package of health services.'

Closely related to this problem is the bias of many aid-funded projects in favor of an excessive reliance on imports. In deciding the extent to which the goods and services purchased for relief, recovery, and reconstruction should be imported, as opposed to being procured locally, donors face another tension between short-run expediency and long-run capacity building (the capacity in this case being in the private sector). Again there are undoubtedly cases where the former trumps the latter: for example, where local sourcing would require large investments with long gestation periods. But there are also cases where local procurement could do more to stimulate economic recovery, and perhaps save money in the process.[28]

To cite an example of the pervasive bias against local suppliers, during the United Nations Transitional Administration in East Timor, some quarter of a million desks and chairs for local schools were purchased with money from the World Bank-administered Trust Fund for East Timor. At the time, some Timorese officials suggested that some of these be procured locally to spur the growth of small and medium woodworking enterprises. The international officials rejected this on the grounds that local procurement would be too slow (Pires and Francino 2007, pp. 141-2). This was not a life-or-death case of emergency food supplies where time was of the essence; the goods in question were school furniture.[29]

The interwoven challenges of building an effective state, a robust economy, and a durable peace all require thinking about tomorrow, today. Postwar inflows of external assistance cannot be sustained indefinitely. The success of this aid ultimately will rest on whether the structures built with it can be sustained without it.

8. Odious Debts? Facing war's financial legacy

Large external debts are often among the baneful legacies inherited by a postwar government. These debts impede the war-to-peace transition in two ways. First, debt-service payments absorb scarce resources that otherwise could be allocated to peacebuilding expenditures. Second, the overhang of accumulated debt deters investment and new lending to the country.

The original loans often were of dubious benefit to the country's people. Indeed, insofar as they financed predatory and oppressive regimes, some of the loans not only failed to benefit the majority of the populace, but may have actively harmed them.

To cite a stark example, after the fall of the Taliban regime the Russian government claimed that the new Afghan government owed it $10 billion, most of it for aid provided in the 1980s when the Soviet army was fighting in Afghanistan. The Karzai administration refused to accept this obligation, arguing that 'the Soviet Union spent the money for its own political and strategic purposes, not to benefit the Afghan people.'[30] This argument echoes the stance taken a century earlier by the U.S. commissioners at the Paris peace conference after the Spanish-American war. At issue were the external debts incurred by Cuba under Spanish colonial rule, and whether these would be passed to the new Cuban government. The U.S. repudiated these debts on the grounds that the purpose of the loans had been not to benefit the Cuban people but rather to finance 'the continuous effort to put down a people struggling for freedom from the Spanish rule.'[31] In international law, this became known as the 'doctrine of odious debt.'[32]

The Russian claims in Afghanistan might be seen as lying at one end of a legitimacy-illegitimacy spectrum, but the legitimacy of many other post-bellum debts can be questioned, too. The Democratic Republic of Congo, for example, inherited a $12 billion external debt from the Mobutu regime (Ndikumana and Boyce 1998). Much of this arguably could qualify as 'odious' debt, in that the Congolese people did not benefit and that the creditors knew or should have known that this would be the case. Similar questions can be raised about the wartime debts incurred by the Angolan government, some of them backed by liens on that country's future oil revenues (Boyce 2005).

Yet the principle that external debts are sacrosanct, unless 'forgiven' by the creditors, remains official doctrine today. In the case the IMF and World Bank, for whom debt write-offs have been taboo until recently, this poses a stumbling block: lending to postwar governments cannot begin until past debt arrears have been cleared. This is usually accomplished by means of bridge loans from bilateral donors, which are used to clear the arrears, opening the door to new loans from the Bank and Fund that in turn are used to repay the bridge loans.[33] By this stratagem, debts contracted by the ancien régime are recycled as fresh debts of the postwar government.

Today there is renewed interest in the doctrine of odious debt. One recent proposal has been to empower an international body – such as the UN Security Council or an independent commission of jurists – to declare governments to be illegitimate, in which case subsequent loans to such governments would be designated as odious (Kremer and Jayachandran 2003). This might curb lending to noxious regimes in the future, but it would not address the legacy of odious debts created by lending in the past.

The case of Iraq has placed the latter issue into the spotlight. Soon after the U.S.-led invasion that toppled Saddam Hussein's regime, U.S. Treasury Secretary John Snow declared: 'Certainly the people of Iraq shouldn't be saddled with those debts incurred through the regime of the dictator who's now gone.'[34] In a similar vein, two former U.S.

Treasury officials proposed the establishment of an international debt commission for Iraq that would examine all outstanding claims and disallow debt that was used for state security or military aggression (Mulford and Monderer 2003).[35]

Such *ad hoc* measures, devised on a country-by-country basis, may be better than nothing. A systematic approach to the problem of odious debt, however, could be implemented by establishing an international institution empowered to adjudicate questions of debt legitimacy in postwar countries. The Norwegian government's call for the creation of 'an international debt settlement court' to hear matters concerning illegitimate debt is a step in this direction.[36] In addition to easing debt-service burdens, an institution with a mandate to review debt claims in postwar countries could function as a financial 'truth commission,' analogous to truth commissions that aid the reconciliation process by documenting responsibility for crimes of violence. The Peacebuilding Commission of the United Nations, established at the request of the September 2005 World Summit, might be an appropriate forum to launch such an initiative.[37]

Apart from its benefits to the public purse in postwar countries, such an institution could have a salutary effect on the functioning of international credit markets in the future.[38] The risk that debts could be declared odious would curb the 'moral hazard' problem that arises when creditors believe that they are insured against the risk of debt repudiation, diluting their incentives to guard against it. The existence of an international debt adjudication body would encourage creditors to exercise due diligence in lending decisions, helping to ensure that future loans are used for *bona fide* public purposes.

Conclusion: Getting priorities right

These public-finance issues have far-reaching implications for policy making by governments and international agencies engaged in the interwoven tasks of postwar peacebuilding, statebuilding, and economic development. There is a pressing need for reforms to align policies more effectively to the dynamics of war-to-peace transitions. These include paying more serious attention to distributional impacts on both the revenue and expenditure sides of fiscal policy; weighing potential tradeoffs between macroeconomic stability and political stability in setting budget-deficit and aid-intensity targets; and devising innovative strategies to address postwar legacies of external debts.

In the arenas of peace implementation and economic development, there is a need for policy reforms aligned to the public-finance requirements of statebuilding. These include devising ways to tap postwar aid inflows so as to prime the pump of domestic revenue collection; moving from the ‘dual public sector’ towards dual control of aid-financed expenditures; and rethinking spending and procurement practices in light the long-term goals of fiscal sustainability and economic recovery.

These reforms would foster greater policy coherence among the many actors engaged in postwar peacebuilding, statebuilding and development activities. Coherence requires coordination among multiple agencies and institutions with the aim of fostering complementarities rather than duplicating efforts or working at cross-purposes. This is no small task. While calls for better coordination have become so frequent as to be almost a platitude, efforts to achieve it run up against the familiar obstacles of bureaucratic rivalries and contests for resources.

Coherence also requires agreement on the ends of policy, as well as coordination of the means. Economic policymakers have devoted a great deal of attention to the problem of ‘getting prices right.’ But ‘getting priorities right’ is a more profound problem, and it has not received commensurate attention. In wartorn societies, building a durable peace should be a top priority for public policy – indeed, arguably it is *the* top priority. Both statebuilding and economic development are central to this goal. Peacebuilding operations could support these processes more effectively. At the same time, statebuilding and development strategies could be reframed with the objective of peacebuilding more firmly in mind. In wartorn societies, the soundness of public finance ultimately must be assessed in terms of its effects on the dynamics of violent conflict.

Notes

[1] Phase I of the Project consisted of retrospective studies, including case studies of Uganda, Cambodia, Guatemala, Timor-Leste, Afghanistan, and Palestine and topical studies on monetary policy and debt management .The present paper is a revised version of the concluding chapter of *Peace and the Public Purse* (Boyce and O’Donnell 2007), the publication resulting from Phase I. Phase II, currently in progress, will produce prospective analyses addressing key areas where policy reforms are both desirable and feasible.

[2] Gupta *et al.* (2004) find a negative relationship between government revenue and conflict in a sample of low- and middle-income countries. Addison *et al.* (2004) report that the intensity of conflict, as well as its presence, negatively affects the tax/GDP ratio.

[3] See, for example, World Bank (2002), DfID (2002), USAID (2005), and SIDA (2006). For an example of an assessment, see Goodhand (2001).

[4] For a review of the rather sparse literature on the distributional impacts of taxation in developing countries, see Gemmell and Morrissey (2005).

[5] Thus at the 1998 meeting of the Consultative Group for Guatemala, the IMF representative urged the government to 'resist pressures to increase import duties or delay the scheduled reduction in customs tariffs,' arguing that 'these actions will have adverse effects on output growth' (quoted in Boyce 2002, p. 47).

[6] For a theoretical critique, see Emran and Stiglitz (2005). For empirical evidence, see Khattry and Rao (2002) and Baunsgaard and Keen (2005).

[7] A recent IMF study (Heller 2005, pp. 4, 21) cites disincentives to mobilize domestic resources as a 'moral hazard' of external aid flows, observing that 'some African countries with among the highest ratios of aid to GDP are also those that have stubbornly low tax ratios.' Examining evidence from a large sample of developing countries, Gupta *et al.* (2003) find that grant aid, in particular, tends to lower revenue efforts; in countries with high levels of corruption, 'the decline in revenues completely offsets the increase in grants.'

[8] Camdessus warned that without a significant increase in the tax effort Guatemala could not expect to receive substantial international aid , and noted that the IMF would have preferred an even more ambitious revenue target. See Boyce (2002, pp. 41-42) and Jonas (2000, pp. 185-186).

[9] Thus among dozens of examples of EU budget-support conditionality listed in a report by the European Commission (2005), the Mozambique case is the sole example of revenue-side conditionality.

[10] 'The Afghanistan Compact,' London Conference on Afghanistan, 31 January – 1 February 2006, p. 12. Available at http://www.unama-afg.org/news/_londonConf/_docs/06jan30-AfghanistanCompact-Final.pdf.

[11] For further discussion of the Afghan case, see Sedra and Middlebrook (2005) and Ahmad (2006).

[12] Pires and Francino (2007, p. 134) give this example from the period of the United Nations Transitional Administration in East Timor (UNTAET): 'There was a little shop within UNTAET grounds that sold alcohol and other goods very cheaply to the international staff. These same goods were often bought and then sold outside at a profit, thus creating black market activities.'

[13] The United States did not sign the Convention (whereas virtually all other member states did so), and hence US citizens and permanent residents employed by the UN are liable for US income taxes. To redress the resulting disparities, a 'staff assessment' is deducted from the nominal gross salaries of UN employees and paid into a Tax Equalization Fund. The Fund is used for two purposes: (i) to reimburse income-tax payments by US citizens employed by the UN, so that net salaries of UN personnel are unaffected by the employee's US tax status; and (ii) to offset the UN budget dues of the other member states that are signatories to the Convention, while the US government receives no offset by virtue of the fact that it taxes UN employees. The staff assessment is sometimes characterized as an 'internal tax' administered by the UN, a description that is misleading in that its purpose is 'to place United Nations staff members subject to taxation [i.e., US citizens and permanent residents] in the position they would have been if their official emoluments were not taxed' (United Nations Secretariat 2007, p. 5).

[14] 'The neoliberal recommendation to national policy makers is that they should insist on maintaining inflation rates of 3-5 per cent,' writes McKinley (2006, p. 352), 'even though there is little empirical evidence to suggest that inflation rates above that level, or even above 10 per cent, have an adverse effect on growth.' For discussion of alternatives to inflation targeting, based on 'real-economy' targets such as employment, see Epstein (2005).

[15] Fro discussion, see Bundred and Levitt (2000) and Dovlo (2003).

[16] In addition, as Heller (2005, p. 7) notes, the exchange-rate impact of aid can be lessened if it is 'used to remove key bottlenecks to improved productivity and productive capacity in the nontradable goods sector.' See also Bevan (2005, pp. 11-12).

[17] The IMF study (p. 49) attributes excessively restrictive policies on aid absorption to Central Bank officials, going so far as to suggest that 'there is a potential cost to central bank independence in the context of aid-dependent low-income countries.'

[18] For discussion, see Eifert and Gelb (2005, pp. 27-28).

[19] For discussion, see Stewart *et al.* (2007).

[20] For a discussion of 'spoilers,' including the distinction between 'limited' and 'greedy' spoilers who are responsive to changing incentives and 'total spoilers' who are not, see Stedman (1997, 2002).

[21] See Boyce (2002, pp. 16-19) and Boyce and Pastor (1998).

[22] For discussion, see Ghani *et al.* (2007, pp. 157-9). For details on the ARTF, see Scanteam, 'Assessment, Afghanistan Reconstruction Trust Fund: Final Report,' Oslo, March 2005. Available at http://siteresources.worldbank.org/INTAFGHANISTAN/Resources/ARTFEvaluationFinalReport.pdf.

[23] For a review of the impacts of corruption, see Rose-Ackerman (1999).

[24] In USAID's program for building schools and health clinics in Afghanistan, for example, 'Employees of a Maryland-based nonprofit relief agency hired to monitor construction quality demanded a $50,000 payoff from Afghan builders – a scene captured in a clandestine videotape obtained by *The Washington Post*' (Stephens and Ottaway 2005).

[25] In Afghanistan, the former planning minister 'has become one of the most popular politicians in the country by campaigning against NGOs [non-governmental organizations], which he has said are more dangerous than al-Qaeda' (Rubin 2005, p. 101).

[26] In exceptional circumstances, dual-control systems can also be applied to domestic revenues (for discussion, see Le Billon 2003). An example is the Governance and Economic Management Assistance Program (GEMAP) instituted in postwar Liberia in 2005.

[27] World Bank (2005, p. 42). This figure excludes counter-narcotics expenditures, which would push the ratio closer to 600%.

[28] The supposed efficiency advantages of foreign sourcing can be illusory. In Afghanistan, for example, where USAID funds for rebuilding schools and health clinics were routed through a New Jersey-based private contractor, press reports have revealed inordinate delays, shoddy construction, and 'extraordinary costs' in the words of a USAID official (Stephens and Ottaway 2005; see also Rohde and Gall 2005).

[29] For discussion of the scope for greater local procurement in postconflict operations, see also Carnahan , Durch and Gilmore (2006).

[30] Ibrahimi and Saeed (2005). Negotiations for a write-off of the Russian debt are ongoing (Paris Club 2006).

[31] Quoted in O'Connell (1967, p. 460).

[32] For discussion, see Hoeflich (1982), Centre for International Sustainable Development Law (2003), and Hanlon (2006).

[33] For example, in December 1995 the IMF lent $45 million to Bosnia – the first loan issued under the Fund's newly created emergency credit window for post-conflict countries. The IMF heralded this loan as 'a new beginning,' but its purpose was simply to allow the Bosnian government to repay a bridge loan from

the Dutch government, which in turn was used to repay Bosnia's assessed share of the former Yugoslavia's arrears to the IMF. Old Yugoslavian debt was thereby transformed into new Bosnian debt. Similarly, in 2002 the IMF lent $543 million to the DRC, $522 million of which was used to repay bridge loans from the governments of Belgium, France, Sweden, and South Africa that had been used to clear IMF debt contracted under Mobutu (IMF, 'IMF Approves US$750 million PRGF Arrangement for the Democratic Republic of the Congo,' Press Release No. 02/27, available at http://www.imf.org/external/np/sec/pr/2002/pr0227.htm). For further discussion of arrears clearance operations, see Alvarez-Plata and Bruck (2007).

[34] Quoted in Beattie (2003).

[35] The Paris Club of official creditors agreed to write of 80% of $39 billion in Saddam-era debts, not on the basis of a determination of which debts were legitimate but rather on the basis of debt sustainability calculations by the IMF. As of this writing, negotiations are continuing on other components of Iraq's $120 billion in external debts (Chung 2005).

[36] See the Soria Moria Declaration on International Policy, October 2005, available at http://www.dna.no/index.gan?id=47619&subid=0.

[37] '2005 World Summit Outcome,' 15 September 2005, paras. 97-105. Available at http://www.un.org/summit2005/documents.html.

[38] For discussion, see Buckley (2002) and Boyce and Ndikumana (2005).

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