FROM THE AMERICAN PEOPLE

Building Fiscal Infrastructure in Post-Conflict Societies

NOVEMBER 2007

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ACRONYMS

ADB	Asian Development Bank
AfDB	African Development Bank
ARENA	National Republican Action Party (Spanish acronym)
BiH	Bosnia and Herzegovina
BNA	National Bank of Angola (Portuguese acronym)
BPS/Flag System	Bank Payments System, Liberia
CACIF	Coordinating Committee of Agricultural, Trade, and Industry and Finance Associations, Guatemala
CFA	Central Fiscal Authority, Kosovo
CONARA	Comision Nacional de Restauracion de Areas, El Salvador
CSA	Civil Service Agency, Liberia
DOR	Department of Reconstruction, Kosovo
EAR	European Agency for Reconstruction
ECOWAS	Economic Community of West African States
ECOMOG	ECOWAS' Military Operations Group
EU	European Union
FDA	Forestry Development Agency, Liberia
FIS	Fund for Social Investment, El Salvador
FISDL	Fund for Social Investment and Local Development, El Salvador
FMLN	Farabundo Marti National Liberation Front (Spanish), El Salvador
FUSADES	Salvadoran Foundation for Economic and Social Development, El Salvador
GEMAP	Governance and Economic Management Assistance Program, Liberia
GDP	Gross Domestic Product
GRC	Governance Reform Commission, Liberia
GTZ	German Technical Assistance Company (German acronym)
HIPC	Heavily Indebted Poor Country
I-ANDS	Interim Afghanistan National Development Strategy
IC	International Community
IDB	Inter-American Development Bank
IFMIS	Integrated Financial Management System
IMF	International Monetary Fund
ITA	Indirect Tax Authority
KLA	Kosovo Liberation Army
KPST	Kosovo Pension Savings Trust
LURD	Liberians United for Reconciliation and Democracy
MDG	Millennium Development Goal
MINUGUA	UN Observer Mission in Guatemala
MPLA	Popular Movement for the Liberation of Angola (Portuguese acronym)

MTEF	Medium Term Expenditure Framework
MTFF	Medium Term Fiscal Framework
MTMF	Medium Term Macroeconomic Framework
NATO	North Atlantic Treaty Organization
NGO	Non-Governmental Organization
NPFL	National Patriotic Front for Liberia
NTGL	National Transitional Government of Liberia
OHR	Office of the High Representative, Bosnia and Herzegovina
ONUSAL	UN Observer Mission to El Salvador (Spanish)
PAYE	Pay-as-you-earn pension scheme
PGT	Guatemalan Workers Party (Spanish)
PRGF	Poverty Reduction and Growth Facility
RAS	Revenue Allocation System (Bosnia and Herzegovina)
RLA	Republic of Liberia Army
RS	Republic of Srpska – Entity of BiH
RUF	Revolutionary United Front, Sierra Leone
SAT	Tax Administration Superintendency of Guatemala (Spanish)
SAFI	Integrated Financial Management System of El Salvador (Spanish)
SIAF	Integrated Financial Management System of Guatemala (Spanish)
SIDA	Swedish International Development Agency
SIGFE	Integrated Financial Management Information System of Angola (Portuguese)
SOE	State-owned Enterprise
SONANGOL	State Oil Company of Angola
TAMP	Tax (Administration) Modernization Project, Bosnia and Herzegovina
TAK	Tax Administration of Kosovo
TIN	Taxpayer identification number
UN	United Nations
UNHCR	UN High Commissioner for Refugees
UNITA	National Union for Total Independence (Portuguese), Angola
UNMIK	United Nations Mission in Kosovo
UNMIL	United Nations Mission in Liberia
USAID	United States Agency for International Development
USG	United States Government
UST	US Treasury
VAT	Value-Added Tax

EXECUTIVE SUMMARY

This paper presents seven case studies of countries that have experienced devastating conflict, costing dearly in lives lost and disrupted, economies battered, and collapsed institutions of political and economic governance. The focus of these case studies is on the building or rebuilding of fiscal infrastructure after the conflict. Fiscal infrastructure narrowly refers to public revenues and expenditures management systems, fiscal policy analysis and policy making support, including statistics. The countries included are from different regions around the world, including: Afghanistan, Angola, Bosnia and Herzegovina (BiH), El Salvador, Guatemala, Kosovo, and Liberia.

Analysis of the case studies reveals considerable commonalities upon which USAID officers and others can develop assistance programs.

In each case considered there were severe fiscal challenges that had to be addressed. Each country experienced slides in national product and hence their tax bases during the conflict period, and large extra fiscal needs arising from post-conflict requirements.

Each country experienced large movements of people, both during the conflict and immediately after the cessation of conflict. In El Salvador and Angola, for instance, people streamed from the countryside, where violence was greatest, to urban areas, especially the capital cities, where there was greater public security. Internally displaced persons in these post-conflict societies require assistance from government in terms of their housing, social services, and, sometimes, relocation.

In a number of instances, the movement of people meant the loss of technically qualified people and the loss of capable civil servants. In most, however, it mainly meant that cadres of capable people were not trained and developed during the conflict years. Angola, for instance, has been able to develop a core set of technocrats who can lead institutions of the state, say in the Ministry of Finance, Tax Administration, Central Bank, and the Budget Department, but there is little depth of skills in these organizations. In Bosnia and Herzegovina, there was very little capable leadership among tax administration, customs operations, and Ministry of Finance staff, at any level, when the war ended, and there are still great holes in capacity now, twelve years later.

In El Salvador, policy analysis came from outside of government, but today there are strong cadres of economists and policy analysts within the government. At the end of the war, there was almost no real budget review and oversight in the legislature in El Salvador, while today there is a small but dedicated experts group within the Legislative Assembly complex to play this role. In Angola there are a few well-trained analysts at the mid- to high levels in government, but the statistical systems they use to steer government action leave them driving the vehicle of state without the basic instruments, such as useful government finance accounts and national economics statistics.

The demobilization of military and guerrillas alike raises the demand for services, relocation, and reintegration. Demobilization and a generation or two at war has led, ironically, to reduced public security in places such as El Salvador and Guatemala, while it is hard to imagine that security could have declined in Liberia or Bosnia and Herzegovina. At the same time, demobilization in Bosnia and Herzegovina certainly did lead to the rise in organized crime. Arms and supplies smugglers, wartime heroes to their people in the various Entities of Bosnia and Herzegovina, continued their criminal ways once the war ended. Issues such as demining and imposing peace throughout the country have had high costs, both in terms of finances and human freedom.

The institutions and human capacity for managing the tax and expenditure systems were not up to the new challenges being faced in any of the countries studied in this paper. International assistance helped in some instances to make up for these inadequate capabilities. But such help, while usually well coordinated, was not always appropriately timed or targeted.

Tax policy needed to be reformed, and it was in some but not all of these countries. For instance, tax policy issues were not addressed in Bosnia and Herzegovina for many years after assistance was already being provided in tax administration. While the US Government (USAID and Treasury) and the European Union (EU) provided assistance to help tax administrations to collect the taxes that were in the law books, Gallagher (2004a) showed that any business actually paying its full tax bill would have to close its doors and go out of business. In Angola, the tax system never really developed because the easy reliance on the oil sector has staved off such reform, but this leaves the country at risk of economic and financial instability, as has been experienced in many other resource-rich countries. In El Salvador and Guatemala, tax policy and administration were both reformed hand in hand, with considerable success. In Liberia, the immediate focus is on improving overall revenue inflows, while tax policy options are being studied.

Post-conflict governments have needed considerable assistance in their budget work, from budget policies, designing public expenditure programs, programming their budgets to be consistent with good macroeconomic requirements and resource availabilities, to the institutional and technical aspects of managing the nuts and bolts of public expenditure management and control. Control over public expenditure management was crucial in each country, as well as building the information systems that go along with this. Such assistance was provided very crucially in Bosnia and Herzegovina, including a complete new national payments system to replace the centralized, non-transparent, Yugoslav-designed and controlling payment system. Both Guatemala and El Salvador ushered in new integrated financial management information systems for control over their entire public expenditure management systems.

In both Bosnia and Herzegovina and Angola, basic information systems have been inadequate to produce comprehensive reports on all of the governments' financial statistics. It is difficult to set budgetary policies consistent with macroeconomic stability while addressing the pressing expenditure demands, if managers and political leaders are not certain of the full dimensions of the public finances, without knowing all the tax revenues, expenditures, and balances. Add to this, the very feeble systems of national accounts in not just these two countries, but also in Guatemala, which recently recalibrated its national accounts—for the first time since 1958—and El Salvador, where the system of national accounts was also recalibrated in the mid-1990s, for the first time in two decades. Liberian national accounts, like much of the Angolan national accounts, are very much influenced by estimates and projections made by IMF staff in Washington, DC. Building statistical systems has not been a central priority in any of these countries, not for the donors and not for the host governments, but perhaps it should be.

In each of these countries, except Angola, donor assistance, and especially US assistance, has been substantial and has helped these new governments address these demands and institutional and resource constraints. Angola, dollar rich but human resource poor, has had to face these challenges mainly on its own. The IMF and the World Bank have willingly provided advisory assistance, but, for the most part, have not provided much assistance in capacity building. The Government of Angola is the only one of those studied here to fund entirely its program of treasury modernization and the implementation of a government-wide integrated financial management information system.

Timing or sequencing of interventions is important, but strategic thinking and planning are necessary to ensure that in the rush to collect revenues we do not cause unforeseen harm to the nascent private economy. Making an effort to collect indirect taxes, such as customs duties and excises, should be given precedence over implementing more complex, modern taxes on corporate and personal incomes, but we should be thinking about the latter all along.

Based on the case studies, a number of lessons emerge that can help build the fiscal infrastructure in these rebuilding countries, but these are merely guides rather than hard and fast rules or instructions. Each country is unique and specific country knowledge must inform our strategic planning and program implementation.

1 INTRODUCTION

Two very important aspects of aiding post-conflict societies and putting them on the path of peace and prosperity are to address some of the basic causes of the conflict and also to set up or reestablish the fundamental institutions of economic governance. Building capacities in fiscal institutions is a basic building block in addressing both these concerns. Societies cannot recover and modern economies cannot develop without the appropriate fiscal infrastructure. Social injustice cannot be addressed, ethnic tensions cannot be assuaged, and peace and security cannot be assured, without a sound fiscal system.

Revenues are needed by government to fund programs that aim to redress some of the grievances that may have been at the root of the conflict, whether this means getting education and health services to the rural areas of Guatemala, reducing poverty in El Salvador, or building new nations, such as Bosnia and Herzegovina (BiH) and Kosovo.

After conflict the basic institutions of society and of economic governance must be built, strengthened, or developed. Among these are systems for maintaining control on government finances and battling fiscal corruption. The rules and institutions for the private sector, its incentive system and its interactions with government must be established. This includes a tax system that encourages good economic decision making by business, while providing adequate revenues for the government coffers.

This paper draws lessons about implementing fiscal strengthening programs in post-conflict countries based upon the experiences of Afghanistan, Angola, Bosnia and Herzegovina, El Salvador, Guatemala, Kosovo, and Liberia.

It is important to keep in mind that none of the countries included in this study, were paragons of economic development and progress before stumbling into conflict. Afghanistan only recently had slipped from an almost formal feudalism to a terror state. Angola was a colony seeking independence and had never had a chance in recent centuries to forge its own indigenous development trajectory. BiH was part of the Yugoslav socialist system, which had it not collapsed into warfare, certainly was on its way to economic collapse just like the rest of the Balkans. Liberia was already backwards before the tumult that began with the overthrow of President Tolbert in 1980. None of these countries were development champions and armed conflict or no, these countries were not keeping up with the rest of the world's progress.

The focus of this paper is to draw lessons that can provide guidance for strengthening fiscal policies and fiscal infrastructure in post-conflict societies. From the policy perspective this means our focus is overall fiscal policy and stabilization, taxation, and government spending. For the purposes of this paper, fiscal infrastructure encompasses those efforts to strengthen or establish

> ***The War-Torn Economies:*** There are many common features to war-torn economies. The negatives dominate. In all cases GDP/capita falls; the population moves, driven elsewhere by the fighting; even with peace, security may be fragile, particularly in the countryside; the infrastructure is typically in poor shape, more through years of neglect than because of war related destruction; inflation is generally high and the exchange rate overvalued, and the financial system is very weak; the fiscal system is also weak, but the peace dividend that might accompanying lower military spending is usually illusory; the industrial sector tends to be abnormally small; social indicators are weak; and institutions, such as property rights, trust, and statistical services, tend to have been undermined.
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> *Haughton, Jonathan, (1998) p.4*

fiscal policy analytic capabilities, tax administration and receipts management, public expenditure planning, management and implementation, and government financial statistics.

In each of the countries included in this study, the fiscal situation at the cessation of conflict was dire, but in some it was much worse than in others. In each case there were fiscal challenges to be met, and in several of these cases, the international community provided important assistance to help meet these challenges. The situations varied widely, as did the response of the international community.

In all cases, these are underdeveloped economies and avoiding future conflict requires addressing this underdevelopment, as well as building the fiscal system.

The paper first reports briefly on each country, the nature of its conflict and the efforts to address the post-conflict fiscal challenges. This is followed by a discussion of the steps that have been implemented, or remain to be implemented in the course of building the fiscal infrastructure for transforming economies and societies. The final section of the paper is a summing up of lessons learned from this cross group of experiences, as well as some guidelines for sequencing interventions.

2 AFGHANISTAN

Nature of the conflict

After a 40-year period of stability in Afghanistan under the rule of King Mohammed Zahir Shah, in 1973, the king's cousin and brother-in-law, Mohammed Daoud Khan, launched a bloodless coup. In 1978, the communist People's Democratic Party of Afghanistan launched a further coup and took over the government.

In December 1979, the Soviet Union invaded with the backing of 100,000 Afghan pro-communist forces, sparking a 10-year war with anti-government Mujahideen forces. As part of its Cold War strategy, the US government began covertly funding and training the Mujahideen insurgents. Faced with mounting international pressure and a great number of casualties on both sides, the Soviets withdrew in 1989.

The era of Soviet occupation and conflict resulted in anywhere between one and two million Afghan civilian deaths and forced more than five million Afghans to flee the country. The vast majority of the elites and intellectuals had escaped to take refuge abroad, leaving behind a dangerous leadership vacuum. Fighting continued among the victorious Mujahideen factions, eventually giving rise to a state of warlords. The chaos and corruption that dominated post-Soviet Afghanistan in turn spawned the rise of the Taliban. The Taliban developed as a politico-religious force, and eventually seized Kabul in 1996. By the end of 2000, the Taliban had captured 95 percent of the country, aside from the opposition (Afghan Northern Alliance) strongholds primarily found in Afghanistan's northeast region. The Taliban managed to eradicate the majority of the opium production by 2001. Yet Taliban rule came at a severe cost. Much of the population experienced restrictions on their freedom and violations of their human rights. Women were banned from jobs and schools. Those who resisted were punished harshly.

The US-led military campaign in Afghanistan, following the September 11, 2001 attacks, resulted in the collapse of the Taliban regime in late 2001.

Village outside Kabul

The situation was dire. Prior to the 1979 Soviet invasion, Afghanistan had been gradually emerging from being one of the world's poorest and least-developed nations. Modest progress in developing irrigated agriculture, an education system, and physical and social infrastructure had been wiped away by a decade-long resistance against Soviet occupation, internal tribal dissention and conflict, government misrule and collapse, several years of drought, and destruction wrought by the NATO-supported military campaign. The lack of institutions, collapse of the currency, dearth of skills, and sheer poverty made rebuilding the country a gargantuan task.

In December 2001, leaders of the former Mujahideen groups and the Afghan diaspora met in Bonn under United Nations auspices to agree on a transitional process leading to elections for a broad-based, gender-sensitive, multi-ethnic, and fully representative Government. The Bonn Agreement provided a framework for the creation of a legitimate government. An Afghan Interim Administration (AIA) was appointed and governed for six months until an emergency *Loya Jirga* (grand council) of some 1,500 delegates could be convened in June 2002. The *Loya Jirga* chose a new Afghan Transitional Administration (ATA), headed by Hamid Karzai. The ATA then set to work on preparing a new constitution, which was signed into law in January 2004. Presidential elections were held in October 2004, in which Karzai prevailed as Afghanistan's first democratically elected head of state. Elections for the Wolesi Jirga (the lower house of the National Assembly) and for Provincial Councils took place in September 2005.[1]

Even before the AIA was appointed, the international community had held a number of meetings on Afghanistan's reconstruction, starting in the fall of 2001. These culminated in the creation of a reconstruction Steering Group—co-chaired by the United States, Japan, Saudi Arabia, and the European Union—and the completion a preliminary needs assessment for reconstruction. Donor conferences in January 2002, and again in March 2004, resulted in pledges of roughly US$13 billion for the reconstruction effort.

Between 2001 and 2003, the leadership and ownership of the reconstruction process were steadily transferred to the Afghan authorities. In 2002, the authorities adopted a National Development Framework (NDF), which focused on three pillars of development: (1) security and human development, (2) rebuilding physical infrastructure, and (3) creating an enabling environment for private sector growth.

Addressing the post-conflict fiscal challenges

The fiscal rebuilding process started from a very low base in Afghanistan. Three decades of conflict had led to the degradation of both physical and human capital. The human resource base in government had been virtually obliterated. The scarce Afghan talent that remained within the key economic institutions were swiftly hired by the multiplicity of donors—the IMF, World Bank, DfID, European Union, Asian Development Bank and UNDP—all supporting specific programs within ministries and the central bank. Along with the lack of human capital in government was the sheer lack of data, facilities, capacity and infrastructure. When the Interim Administration took office in January 2002, there were no computers in the Ministry of Finance; communications and other links with the provincial administrations, moreover, were weak. The frequent recourse to overdraft financing from the central bank meant that there was no focus on cash flow management or financial reporting.[2] Compounding the problem, the ATA was a coalition government, deeply divided on nearly every issue except for a common opposition to the Taliban, and its effective authority had not yet extended beyond Kabul.

Notwithstanding the challenges, significant progress had been made in the fiscal arena by the time of this writing. The budget has become a credible instrument for implementing policy, and in the process restored confidence in the Ministry of Finance. The government has adopted a Medium Term Fiscal Framework (launched in October 2005), integrated the operating and development budgets, and brought its budgets into closer alignment with the country's overall development strategy. From a dysfunctional payment system and a weak control framework, budget execution and fiduciary controls have been put in place with the implementation of the centralized, computerized Afghanistan Financial Management Information System (AFMIS) and the Treasury Single Account. Furthermore, a modern regulatory framework has been adopted, with the Public Finance and Expenditure Management Law and associated regulations, the Procurement Law, and a system to monitor and disclose procurement activities. And, in 2005/06,[3] the budget was audited for the first time and the audit report was sent to Parliament in a timely manner. These developments have helped increase the implementation ratio of the budget and raised fiduciary standards. On the revenue side, meanwhile, significant strides have been made in the area of customs and, to a lesser extent, in tax policy and administration. Revenue performance continues to fall short of targets and is driven mainly by collections at the border.

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1 Bennett et al. (2005), p. 1.

2 Carnahan et al. (2004), p. 3.

3 The Afghan fiscal year runs from March 21st to March 20th of the next calendar year.

A number of these achievements were made possible by sustained technical assistance. Developing in-house capacity remains a critical challenge for the Government. Some of the key issues and developments in rebuilding Afghanistan's fiscal infrastructure are discussed in detail below.

Budget planning[4]

Although the interim administration took office on December 22, 2001, almost nothing happened for the first several months because the administration had almost no money and no experience in public administration. There were also at least four other major impediments to preparing the budget. First, there was no statement of actual expenditure for 2000/01, and an examination of the 2001/02 budget revealed that well over half of the funds were allocated into either discretionary funds controlled by the President or the Ministry of Finance, or to the Ministry for the Promotion of Virtue and Eradication of Vice. Second, there was no clearly agreed staffing structure from which to derive the wage bill. Third, there was little support within the ministry for changing the status quo, which appropriated most resources into discretionary funds. Finally, around half of the ministries comprising the interim administration did not exist during the Taliban regime—rather, they were created during the Bonn Meetings in December 2001. Accordingly, these ministries had little experience with budgeting.

Against this backdrop, the preparation of the 2002/03 budget was a challenge. The process began in January 2002 and involved the Ministry of Finance and the line ministries meeting to discuss staffing numbers. A draft budget was prepared jointly by international advisers and senior officials of the Ministry of Finance, amid considerable disagreement within the cabinet over the relative allotments of budget funds (the defense budget was a particularly thorny issue) and the scale and nature of off-budget spending. These off-budget expenditures included revenues earned in embassies overseas; expenditure from revenues collected at the provincial level that were not reported to the center; and, expenditure from assistance provided by neighboring countries.

A budget decree was drafted, approved and, with the appropriation schedule attached, agreed to by the cabinet and passed into law in early April 2002. Among the decree's general policy pronouncements was a clause that forbids overdraft financing, which has been rigidly enforced ever since.

As budget making has evolved in Afghanistan, the government has significantly increased its control over the allocation of resources. The 2002/03 budget, for instance, was primarily descriptive—largely summarizing the probable recurrent costs of running government and the donor-funded reconstruction projects. Since then, the budgets have become more prescriptive and are increasingly used as tools for forcing policy tradeoffs and allocating resources to the government's highest priority tasks.

Budget execution/Public expenditure management

A critical early step in the rebuilding process was laying the foundations for a treasury accounting system within the Ministry of Finance. With USAID assistance, a system for computerized check issuance was launched in Kabul in October 2002. This enabled "real-time" reporting of all expenditures processed through Kabul. By the start of 2003/04, the AFMIS system had been expanded to allow for control of budget execution against budget allotments—again, for all expenditures processed through Kabul. Further modules were rolled out over subsequent months, including a module for recording of revenues. In addition, a Treasury Single Account was established, centralizing management of all cash balances in the central bank, Da Afghanistan Bank, reducing opportunities for discretionary (non-budgeted) spending across the central and regional governments.[5]

Notwithstanding the introduction of AFMIS, the inability of the Government to manage its own resources prompted donors to plan and execute

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4 Much of the information in this section was taken from Carnahan et al. (2004).

5 Carnahan et al. (2004), p. 20.

development projects directly, creating parallel structures both in institutions and in service delivery organs. A 2005 World Bank report noted:

> *"There are important lessons for donors as well, including the need to work through Government budget channels and not build up parallel structures, … resist "flagging" of projects/activities that they finance to the detriment of the Government's visibility, and encourage rather than undermine cost containment for example by supporting competition in their own and Government procu*rement procedures."[6]

By bypassing the Government and taking matters into their own hands, donors have impeded progress to some extent, and reduced confidence and pride in the Government machinery.

The Afghan Government has taken gradual steps to increase donors' confidence. In 2004, the Government introduced the concept of a *core* budget (all funds flowing through the Treasury Single Account)[7] and an external budget (directly executed by donors and outside of the Treasury Single Account). Donors are increasingly heeding the Government's plea and supporting the principle of the *core* budget for both operating and development expenditures.

As Table 1 shows, the external budget accounted for two-thirds of all spending in 2005/06, decreasing slightly from 2004/05, and is projected to drop significantly from 2007/08 onward. Operating expenditures, 60 percent of which go to wages and salaries, continue to account for the majority of core budget spending, but core development expenditures are projected to increase steadily over the next several years.

The core development budget, flowing via the Government's accounts, is estimated to have increased by about 58% in 2005/06, and again by 70% in 2006/07, reaching an estimated 8.4% of GDP. The Government has developed measures to further implementation capacity and the development budget is estimated to reach over US$1.2 billion in 2007/08. Budget implementation is satisfactory in some sectors, e.g. health and rural development, but weaker in others, such as the infrastructure sectors. While the Government has come under criticism for poor implementation, the sheer size of development expenditures is also huge. By way of comparison, Afghanistan's reconstruction commitments are more than five times those pledged for Bosnia and Herzegovina.

Revenue challenges and fiscal sustainability

This section reviews the issues related to attaining fiscal sustainability, which is a central concern for Afghanistan. Because donor assistance is inevitably temporary, the Government's inability to produce sufficient revenues to finance the budget would have grave implications for economic growth and stability.

For nearly five decades preceding the Taliban's fall, domestic revenue collections had been as erratic as the political arena. Although the levels of tax collections have varied through time, the composition of domestic revenues has been stable, with custom duties as the most important source of income, followed by non-tax revenues and limited collections from direct taxes.

Through the 1960s, indirect taxation accounted for most of the revenues, and only about 12% of the public revenues were from direct taxes, including land and personal property taxes and individual and corporate income taxes. By the end the decade, incomes from monopolistic enterprises owned by the Government became a more important source of revenue. Following the

6 World Bank (2005).

7 The Government's core budget pays for goods and services and minor capital. Core operating expenditures (US$1,072 million in 2007/08) are financed from five sources: (i) domestic revenues (US$715 million); (ii) grants via the Afghanistan Reconstruction Trust Fund, which finances both ordinary and some development expenditures (US$270 million); (iii) the grant of Law and Order Trust Fund, which finances the compensation of the Afghan National Police (US$127 million); (iv) external concessional loans; and (v) changes in cash balances at the central bank. A significant amount of expenditures for capital and goods and services are covered through the external budget and unrecorded in the Government's accounts.

TABLE 1: FISCAL TRENDS IN AFGHANISTAN, FROM 2003

	2003/04	2004/05	2005/06	2006/07 (est.)	2007/08 (proj.)
		Percent of GDP			
Domestic revenue	4.5	4.5	6.4	6.4	7.2
Tax revenues	2.8	3.4	3.9	5.4	6.0
Nontax revenues	1.7	1.1	1.8	1.1	1.3
Donor grants to operating budget	4.5	5.3	4.6	4.4	3.8
Donor grants to development budget	2.0	2.9	5.3	4.3	5.2
Total core budget expenditures	14.0	13.9	14.7	18.9	19.0
Operating expenditures	9.8	9.4	8.9	10.5	10.1
Development expenditures	4.2	4.5	5.8	8.4	8.9
Operating budget balance (excluding grants)	-5.3	-4.9	-3.2	-4.1	-2.8
Operating budget balance (including grants)	-0.8	0.4	1.4	0.3	1.0
Core budget balance (including grants)	-3.0	-1.2	0.9	-3.8	-2.7
External budget expenditure	33.1	35.2	27.5	26.1	18.6

Source: IMF Country Report No. 07/130, March 2007.

Soviet period and several years of political unrest, the revenue system deteriorated and foreign aid from the Soviet Union and other member countries of the Council for Mutual Economic Assistance began to play a central role. The fiscal situation became even more unstable after the collapse of the Soviet Union and the opening of the borders to Central Asia. Smuggling through Afghanistan rose sharply. After the withdrawal of Soviet forces in 1989 and before the Taliban fully took control in the mid-1990s, the anarchy and warlordism that arose practically obliterated an already crippled revenue system. The revenue-to-GDP ratio dwindled from 3.3% in 1989 to 0.3% in 1995, just before the Taliban took power. The ratio of expenditures to GDP, on the other hand, kept pace—starting at 10.5% of GDP in 1989 and ending at 7.9% of GDP in 1995, with decline and rise over the period.

The Taliban regime introduced an "Islamic tax" (*zakat*), levied at a rate of 10% on all individuals' income. The Mustufiats, the provincial administration offices of the central government, applied this ruling to all employees in the public and private sectors. In addition, taxes were levied on imported goods, agricultural production, and landholdings.

As reconstruction began, the major goal was to design a fundamentally sound policy framework for revenue mobilization, able to sustain both the short-term need for revenue and the long-term need for a market-oriented tax system.

Customs reform formed a crucial part of this agenda. With USAID assistance, nearly two dozen border entry posts were set up with Customs facilities. New Customs legislation was introduced, providing traders with a simple, modern and predictable code and providing the Customs Department with standard operating procedures. In addition, the tariff structure was simplified, reducing the prior 26 rates and replacing them with a four-tier system. The previous 0-150% rate structure became a more manageable 0, 5, 10 and 25%.[8]

Customs reform contributed to a two-fold increase in customs revenue between 2001/02 and 2004/05. Customs revenue continues to account for more than half of all domestic revenue.

Tax policy and administration also saw considerable change during the reconstruction period. With USAID assistance, the Government introduced several new, easy to administer taxes, including a rental services tax, business receipts tax, and a wage withholding tax. A new legal framework for tax administration was adopted, and a new tax identification numbering system rolled out, resulting in significant increase in registered taxpayers between 2003 and 2005. In addition, audit, enforcement and taxpayer education and assistance programs were set up, and a Large

8 Bearing Point (2005).

Taxpayers Office established with associated staffing and training to begin to foster a culture of voluntary compliance in the tax system.[9]

Despite these efforts, however, inland revenue collection has remained low. Domestic revenue reached US$470 million (6.4% of GDP) in 2004/05 from US$209 million (4.5% of GDP) in 2002/03. By comparison, for 2005, the revenue-to-GDP ratios in neighboring Tajikistan and Pakistan were 17.7% and 13.7%, respectively. As a result of poor revenue collection, the Government's operating budget, excluding grants, remains in deficit (see Table 1 above). The Government has committed in the 2005 *Afghanistan Compact*, which lays out the mutual commitments of the Afghan authorities and the international community through 2010, to increase its domestic revenues to 8% of GDP by 2010/11. The Government intends to cover its operating budget by 2012/13, although major security expenditure will require continued support.

Afghanistan's low revenue effort underscores the need for urgent measures to help the Government reach and preserve fiscal sustainability. The challenge is to find a mix of revenue policies that can be effectively available to the Government, recognizing the institutional limitations in tax administration and the difficult economic, political, and security conditions—high incidence of poverty and unemployment, low incomes and savings, weak domestic production, and armed conflict, among others—that constrict the range of policy options. Recent studies suggest that raising the share of revenue as a percent of GDP to 15% should be seen as a minimum objective.[10]

Looking ahead, the government's revenue reform strategy has four priorities. First, simplify the tax code to eliminate "nuisance" taxes and move toward a broad-based consumption tax. Second, the emphasis in tax administration includes strengthening the Large Taxpayer Office and strengthening provincial Mustufiats. Third, continue to implement the five-year strategic Customs administration plan (e.g., refurbishment of border posts, roll-out of ASYCUDA). Fourth, review customs and tax administration to assess vulnerabilities to corruption and implement mitigating measures.

Outlook

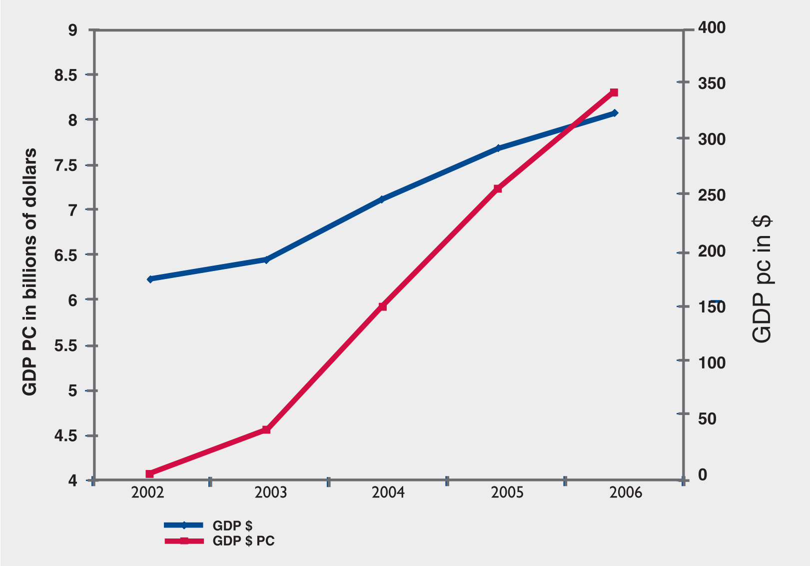
The Government's macroeconomic framework is stable. This was evident from the successful completion of the IMF's Staff Monitored Program (2004-2006). However, the growth objectives and a sustainable fiscal agenda are associated with substantial risks. The scenario assumes: (i) continuing political normalization and steady progress on the Government's reform program, (ii) improvements in security conditions; (iii) continued donor support; (iv) a private sector increasingly replacing the opium economy; (v) on-going support for the security sector ; and (vi) efforts to curb corruption and bolster revenues. By far the greatest risk, overshadowing the others, would be a worsening political and security situation. Lack of progress in this area would negatively affect both the willingness and capacity of donors to support Afghanistan's reconstruction effort. It would also further reduce the Government's ability to enforce the rule of law and implement its development programs. A deteriorating political and security situation would also favor the continuation of extensive poppy production, exacerbating its negative impact on governance and worsening the licit business environment in many parts of the country.

Afghanistan's economy, as shown in Figure 1, has achieved a major recovery from the end of Taliban rule. The real value of non-opium GDP has increased by 16% on average over the last four years. GDP per capita is estimated at about US$300 (excluding opium), up from less than US$200 in 2001. Economic growth has been particularly strong in services and construction, driven by the reconstruction effort. The legal economy is dominated by small-farm agriculture and other primary sector industry with traditional methods of production. Secondary and service sectors are still limited to a few industries.

[9] Ibid.

[10] Heller (2005).

FIGURE 1: ECONOMIC GROWTH PATH IN AFGHANISTAN[11]



One of the consequences of instability has been a resurgence of the opium economy. Its share in the economy went down from 38% in 2002/03 to 26% in 2004/05, but in 2006 production increased to an unprecedented 6,100 tons. Drug-related corruption and crime undermine the institution-building process, and parts of some institutions, notably in the security sector, appear to have been seriously compromised by illicit drug trade. Opium production has also distorted the economy and discouraged the development of licit economic activities.

A currency reform was completed in early 2003. Monetary policy has been restrained, supported by adherence to fiscal discipline and a no-overdraft rule that prohibits central bank financing of the deficit. The nominal exchange rate is stable, while the real exchange rate is slowly appreciating owing to the significant inflows of foreign exchange.

Economic developments in 2006/07 have been broadly satisfactory. The impact of the drought on agricultural production was somewhat stronger than previously anticipated, with real GDP growth decelerating to about 7.5% in 2006/07, from 14% in 2005/06. Annual end period inflation, as measured by the consumer price index for Kabul, dropped to 4.8% in March 2007 because a decline in rent prices mitigated the impact of rising food prices and an increase in administered energy prices in the latter part of 2006/07. Annual end period "national" inflation, covering Kabul and five other cities, was 3.9% in March 2007.

Since 2001, security has been a major challenge in Afghanistan. The situation deteriorated in 2006, stabilized somewhat during the winter, but remains volatile. Sources of insecurity are complex, with increased insurgency (particularly in the southern and eastern regions), criminality, drug-related activity, and terrorism.

Lack of security has thwarted development activities and challenges remain enormous. Nevertheless, Afghanistan has achieved significant results in the last five years. Following the presidential elections, the new administration began emphasizing the importance of moving from the concept of post-conflict emergency management to a more medium-term, sustainable development framework and increasing government ownership of policies. Two decades of conflict had reduced physical and social infrastructure to skeletal proportions. A coherent administration was non-existent. Social indicators were among the world's lowest, and simply maintaining security was an immense challenge. This transition has necessitated reorienting efforts from day-to-day management in ministries and agencies to emphasizing forward-looking strategies. Establishing institutions and the processes necessary for a peaceful political transition has been at the forefront of the Government's agenda. Weak capacity has impeded this ambition.

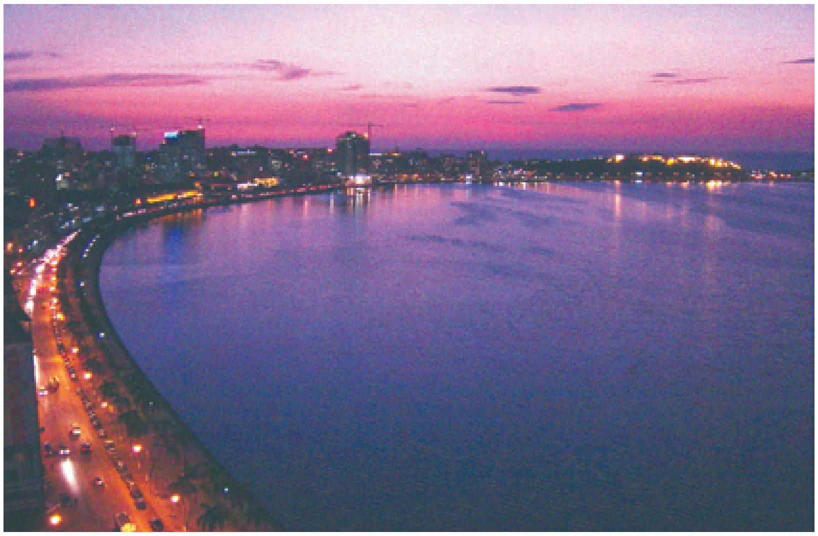
Meanwhile, fiscal pressures loom from (i) expenditures previously funded by donors that have come on budget; (ii) additional spending associated with the deteriorating security situation; (iii) the cost of additional teachers to meet the targets of the country's poverty reduction strategy; (iv) clearing of arrears to teachers, police, and utility companies; and (v) the inclusion of higher operating costs from the development budget.

[11] Data are from World Economic Outlook database, April 2007.

The country is also subject to high debt distress: as of March 2006, the debt-to-GDP ratio was 163%. In mid-2006, Afghanistan initiated negotiations with the Paris Club, and in April 2007 the World Bank and IMF deemed Afghanistan eligible for debt relief under the Heavily Indebted Poor Country (HIPC) initiative. The agreement with the Paris Club will lead to canceling approximately US$11.3 billion in external debt to its three Paris Club creditors—Germany, the Russian Federation, and the United States—bringing the 2005/06 debt-to-GDP ratio down to about 20%. The agreement also calls for comparable treatment from other bilateral creditors. The HIPC Completion Point is estimated to be mid-2009, when HIPC debt relief becomes irrevocable and additional assistance is provided through the Multilateral Debt Relief Initiative. Macroeconomic reforms, prudent debt management, and continued donor support on highly concessionary terms will be needed to restore sustainability over the medium term. HIPC Completion Point triggers would include reforms in the areas of public financial management, external debt management, and public expenditure policy. The planned debt relief should help Afghanistan remain on track with its development program.

3 ANGOLA

Nature of the conflict



Luanda's Marginal at dusk

Angola gained independence from Portugal in 1975, and then immediately went into a tailspin of a 27-year internal rebellion. The rebellion pitted ideological opposites against each other: an ostensibly African Socialist regime led by the continuing President, Jose Eduardo dos Santos and his Popular Movement for the Liberation of Angola (MPLA) and the supposedly democratic, western-oriented rebel movement called National Union for Total Independence of Angola (UNITA), led by Jonas Savimbi. The Government-backed MPLA had military and economic support from the Cuban government, while UNITA was given succor from South Africa, with US backing. Although ideology was involved, and the war was one of the East-West proxy wars of the cold war era, oil and diamonds helped to fuel the conflict for such a protracted period.

In 1992, the country held presidential elections, and although reports are that President dos Santos had not actually gained a majority of the vote, he nonetheless maintained control and is still in power today. Elections have been scheduled for each of the last several years, but have still not been realized, as of this writing.

UNITA had been slowing in its offensive, making very little headway. International support for the rebels was waning and the world's thirst for oil was growing. In 2002, Jonas Savimbi was killed and the UNITA insurgency came to a halt. The MPLA and dos Santos have been consolidating power and there is peace in the country.

The wars for independence and the civil war that followed took a high toll on Angolan society, and according to some estimates resulted in the deaths of about 800,000 people, or about 7% of the national population. Democracy has not been borne of this tragic era, but weariness with politics and conflict seems to have taken a hold of the people.

The Government has been interested in implementing a number of economic reforms, including a movement toward the private-sector oriented market economy. Everything economic in Angola since the end of the war is tied to new investments in oil, increasing oil production and rising international oil prices.

Despite the devastating effects of the war on the population and the country's prospects, the oil industry seems to have been able to continue operations throughout most of the strife, and has become the ultimate enclave economy. Even today, with peace thriving and oil production and revenues soaring, the oil economy has few linkages to the rest of the economy. Its main contribution to economic development is to fund a large share of the Government's budget, yet it creates few jobs and few opportunities for upstream or downstream economic activity.

Addressing the post-conflict fiscal challenges

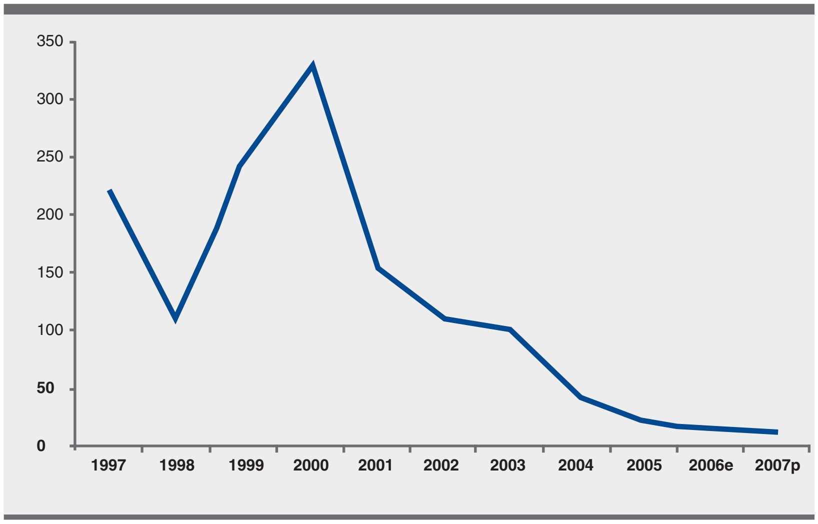
Angola found itself in fiscal difficulties long before the final cessation of hostilities in 2002. In the early 1990s, the country was running large fiscal deficits to fund its array of spending subsidies as well as to keep the war going, while not implementing any modern taxation instruments. The petroleum sector at that time was the only part of the economy that was working well, and it financed about all of government operations, the remainder of which was financed by mostly domestic borrowing.

The large fiscal deficits were mainly financed by domestic credit expansion and the creation of base money. This led to several years of very rapid inflation. In 1995, inflation had reached over 2,600% and in 1996 it topped 4,000%. Of course, the real effective exchange rate appreciated rapidly, too, rendering any other possible economic activity in the country non-competitive. These deficits continued into the recent past, with inflation also continuing. After 2002, however, the Government and the National Bank of Angola (BNA) managed to reign in somewhat the fiscal deficits, thanks to rising oil revenues, and have cut back the dependence on domestic finance and money creation.

With the rapidly rising prices for petroleum since 2004 and the increasing output from new discoveries and new wells, Angola has been able to reverse its fiscal situation, turning deficits into large fiscal surpluses of more than 20% of GDP. Today, inflation has been brought much more under control. The IMF estimates inflation in 2006 to have been about 13% and is projecting it to decline further to slightly higher than 10%. Yet, a number of pressing problems persist.

Angola's economy has been one of the fastest growing economies in the world. It owes this growth to the country's rapid increase in petroleum production coupled with the climbing price of crude oil on world markets. This booming economy has yielded high returns to the Government of Angola in terms of rapid rises in its revenues. Petroleum revenues amounted to more than 85% of all government revenues in 2006, while Table 2 shows that total government revenues came to about 71% of GDP last year. While rapid growth in oil revenues led to large overall fiscal surpluses in recent years, the long-term implications of government spending has pushed up the "non-oil" fiscal deficit from 23% of GDP in 2004 to 37% last year. This leaves the country at some risk. Any declines in oil revenues, from price declines or production shortfalls, can have serious implications for the fiscal situation and the overall economy.

FIGURE 2: INFLATION IN ANGOLA[12]



Budget control

The Angolan authorities have found it extremely difficult to exercise basic control over their finances for a number of reasons. First, because of the weaknesses throughout almost all other institutions in Angola, the State Oil Company (SONANGOL) has been carrying out quasi-fiscal operations, contracting debt, servicing debt, delivering gasoline to budgetary entities, and paying taxes, net of these quasi-fiscal operations, to the Treasury. Indeed,

12 Data are from World Economic Outlook database, April 2007.

TABLE 2: ANGOLA'S FISCAL SITUATION

	2004	2005	2006
	Percent of GDP		
Total revenues	45	41	71
Tax revenues	43	40	67
Petroleum sector	36	34	60
Non-petroleum sector	7	6	7
Non-tax revenues	2	1	4
Total expenditures	30	38	44
Current spending	28	34	34
Remunerations	10	9	10
Goods and services	7	12	10
Interest payments	5	3	4
Transfers and subsidies	6	10	10
Capital spending	2	3	10
Current account balance	17	7	37
Overall balance	15	4	27
Non-oil fiscal balance	-23	-32	-37

Data from Ministry of Finance

SONANGOL's quasi-fiscal operations last year were equivalent to 12 to 14% of GDP. SONANGOL is quite adept at managing its own books. But this contrasted with the Government's inadequate capacity and lack of credible systems within the Ministry of Finance, creating a situation where the Ministry has had considerable difficulty accounting for all of the Government's revenues, debts, debt payments, transfers, and expenditures.

The difficulties related to controlling and executing the budget, in part, stem from an inability to even know how much the Government is actually spending, how it finances its expenditures, let alone not having the analytic capacity to project, plan, and organize its budget system in coordination with the rest of the economy to develop a stable, long-run growth path. Donor assistance is providing some support in these areas.

In particular, USAID is providing assistance to the Ministry of Finance in improving the compilation and reporting of fiscal information, and in undertaking macro-fiscal programming. This includes developing a multiyear macroeconomic framework, a revenues projection model, and the start of a Medium Term Fiscal Framework (MTFF) to forecast and plan government revenues, expenditures, and finances and to set and monitor fiscal targets.

Other donors, as well, are providing some assistance in the area of fiscal planning. The EU will provide assistance with developing a government-wide Medium Term Expenditure Framework (MTEF), which goes beyond the MTFF to sectoral and institutional program-related budget planning. Meanwhile, the World Bank is providing assistance in helping the Tax Administration develop tools for forecasting monthly and quarterly receipts.

The rapid rise in petroleum revenues has outpaced both the Government's ability to budget and to execute. The following table amply demonstrates the rapid growth in fiscal surplus, the over-performance on revenues, and the lagging expenditure execution.

TABLE 3: ANGOLA'S BUDGETARY EXECUTION

	% of GDP			Exectution rate		
	2004	2005	2006	2004	2005	2006
Revenues	30.5%	28.7%	43.9%	111%	108%	144%
Current spending	19.1%	25.1%	20.0%	76%	86%	90%
Capital spending	2.2%	3.5%	8.1%	37%	56%	55%
Overall balance	11.5%	0.8%	18.9%	mm		

nm: Not meaningful
Execution rate is the actual level of spending or revenues as percentage of that budgeted.
Data from Ministry of Finance

The Government's execution difficulties do not seem to be uniform throughout. For instance, the Defense budget seems to be fully, even more than fully, executed, while current spending execution in the social sectors is far below that budgeted. Given the country's low public investment rate (about 2% of GDP), the terrible state of physical infrastructure, the dire social needs and requirements related to reintegration of former combatants, and the penury of most people in the country, especially those still waiting for basic housing and other services, such under-execution of the budget, in the face of rapidly rising financial resources, has a heavy cost to society and the continuance of peace and stability.

In 2004 the Government, recognizing its difficulty in adequately controlling and reporting on its public finances, began the design and then implementation of its new Integrated Financial Management and Information System (SIGFE in Portuguese). SIGFE is based on the system that was implemented in Brazil, and, to a great degree, it is being implemented with consultants from Brazil. Angola, however, unlike most other developing countries that have implemented this type of system, is paying for the entire project out of its own current revenues. SIGFE is not just an information management system, it is a complete transactions control system, where expenditures and revenues are entered at the transaction and the information is captured and included in the chart of accounts reporting. The country has established its chart of accounts, as well as its national budgeting system, based on the IMF's Government Finance Statistics methodology and is fully compliant with international standards. However, there are still considerable problems. Many transactions are still outside of SIGFE. SONANGOL, the Social Security System, and several budget dependencies with a degree of autonomy, remain outside of the system, although now SONANGOL regularly reports its fiscal operations to the Ministry of Finance, outside of the SIGFE. Still, these are not under the control of the Treasury and certain data remain obscured in reporting.[13]

SIGFE controls transactions. SIGFE, like most other Integrated Financial Management Information Systems, provides for the control over most government transactions, particularly spending, by automation-supported processes that ensure that transactions are made against budgetary authorities, that they are classified correctly according to the chart of accounts, and that they are recorded in real time and in useful and accessible ways. While most of the Angolan Government's expenditures are now within the SIGFE, certain important institutions and transactions remain outside the system. These include, inter alia: the Social Security Institute, a number of decentralized or semi-autonomous extra-budgetary organizations, as well new debt liabilities incurred via foreign-financed projects. And, of course, SONANGOL is also not subject to SIGFE controls.

These fiscal reporting problems mean that the country continues to have difficulty monitoring and reporting on the fiscal situation. Indeed, in 2005 the Ministry of Finance reported a discrepancy in its accounts coming to about 6% of GDP. Efforts are being made to pull all government finance operations reporting into one central place in the Ministry of Finance, and this discrepancy is not expected for this current fiscal year.

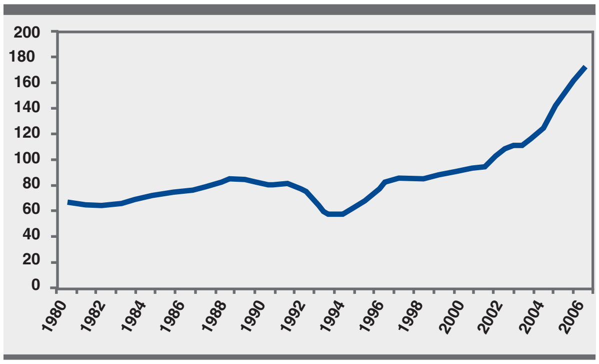
Budget planning

USAID has been providing limited, intermittent assistance to the Ministry of Finance to improve its ability to take a holistic view of its public finance system, integrate the quasi-fiscal operations of the various agents, such as SONANGOL, and to correct the incoming account information from budgetary entities that remain outside the SIGFE. In addition, the USAID assistance is helping to coordinate all these data into a Medium Term Macroeconomic Framework (MTMF) and will soon move to the development of the Medium Term Fiscal Framework (MTFF). These two frameworks are most useful at this time to help indicate the precise weaknesses in the current fiscal data systems, as well as the weaknesses in the system of national accounts.

The European Union is planning assistance to the Government of Angola that will build on the USAID assistance and its intention is to help introduce a Medium Term Expenditure Framework (MTEF). The MTEF should help improve budget planning and hopefully produce better results in terms of more socially worthwhile public spending.

[13] For instance, as of this writing, SONANGOL reports "debt service" as a global figure, not separating our amortization from interest payments.

FIGURE 3: ECONOMIC GROWTH PATH IN ANGOLA



It is still too early to say whether or not these improved management skills and capacities will result in the needed reforms in how public resources are allocated to social needs and long-term economic growth and diversification. The political desire to make these changes, even to recognize the need for such changes, is paramount, yet not obviously apparent. Nonetheless, without these improved statistical bases and analytic capacities, these changes cannot come about. These improvements are necessary but may not be sufficient conditions to addressing the long-term socio-economic requirements of the Angolan people.

Outlook

It is interesting to track the path of Angola's economy over the past two decades. As can be seen from Figure 3, after the peak in 1992, the Angolan economy began to decline again. It was not until 1996 that the economy started to rise up again slowly. However, in 2002, after the end of hostilities and new investment in the oil sector, rapid increases in oil production and rapid increases in international oil prices, the economy took off with unprecedented speed.

Figure 3 clearly shows the economic decline after the elections of 1992 and the new onset of conflict that followed.[14] With the death of Savimbi and a more lasting peace beginning in 2002, investment into the oil sector grew rapidly, oil prices and production took off, and the economy struck a meteoric trajectory. Between 2002 and 2006, the economy, in terms of constant prices, nearly doubled, and prospects are positive for continuing on this growth path for the next couple of years.

Economic growth has been quite rapid, and the economy is estimated by the WEO to have grown by about 35% in 2006 and it is projected to grow another 15% in 2007. This growth is based on oil and will continue to be based on oil. The challenge for Angola is to account for and manage these resources well. Angola needs to continue to strengthen its fiscal accounts, and spend its money well. Economic growth has brought a visible prosperity to the capital city, Luanda, and a few other urban areas, but there are still millions living in poverty in urban and especially rural areas. These people need roads, schools with teachers, hospitals and other economic and social services. The challenge then is to avoid the future pitfalls of the "resource curse" and help to bring some balanced growth with wider distribution of benefits.[15]

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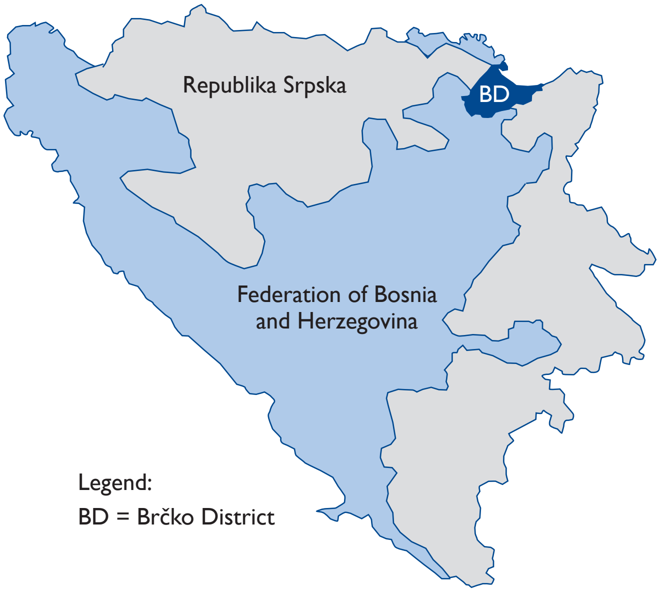
[14] Raw data are from WEO database, April 2007. Real GDP is indexed to 100 in 2002.

[15] For a multi-perspective discussion of the "resource curse" and tools for addressing it, see DAI (2007).

4 BOSNIA AND HERZEGOVINA



Nature of the conflict

In 1992, emboldened by the successful secession of Slovenia, some leaders in Bosnia and Herzegovina (BiH) declared independence from the rest of Yugoslavia. This was followed by a very dirty war, including both Yugoslav regular army forces as well as irregulars or newly created forces of the three main ethnic groups in the country: Bosniaks, Croats, and Serbs. Despite half-hearted efforts of the United Nations, the war continued until NATO finally stepped in and put a halt to the fighting, at the end of 1995. All parties agreed to a peace pact, referred to as the Dayton Agreement, since it was developed in negotiations held in Dayton, Ohio, but which was actually signed on December 14, 1995 in Paris, France.

The Dayton Agreement became the new constitution of the new Bosnia and Herzegovina. It divided the country into two "Entities": that of the Federation of Bosnia and Herzegovina (the Federation) and the Republika Srpska (RS). These divisions resulted in the fractured BiH displayed in the map. The Federation was further divided into ten Cantons, all but one of which are either Bosniak or Croat majority. In addition, a little wedge of territory called Brčko District separates the two halves of the RS, so that this Entity is not fully contiguous. The final status of Brčko District was to be decided within a short time after the signing of Dayton. Today, Brčko District remains separate from both Entities.

The RS is a geographic area that is predominantly made up of ethnic Serbs, while the Federation is made up predominately of Bosniaks and Croats. The Serb makeup of the RS is no accident, since its boundaries are the product of gerrymandering and ethnic cleansing. There remains considerable rejectionism among the country's Serb ethnic group, and most attempts at harmonizing legislation or taxes, or unifying functions across Entities, is looked at with severe distrust by the Serbs, and often by the Croats as well. At the same time, distrust abounds among all three ethnic groups.

The human toll of the war was great. About 200,000 people were killed, and over 1,000,000 were displaced, with much of the housing destroyed. Today, one can drive a good ten kilometers on the road to Drvina, for example, without seeing a single, intact building—not homes, nor schools, nor churches and mosques.

Governance in BiH, today, is a very complicated affair. Almost all politics in the country is based on ethnicity and pseudo-nationalism. To keep the country together, ensure the implementation of the Dayton Agreement, and to help usher in greater unity of the country, the International Community, which had created the Peace Implementation Council comprising members from 55 countries, established the Office of the High Representative (OHR). The High Representative post has always been filled by a European, while the Principal Deputy High Representative, the second highest ranking official in the OHR, has always been an American. The OHR also has a Deputy High Representative serving in Brčko as the Brčko District Supervisor. The Brčko Supervisor position has also always been filled by an American.

The OHR and its functions are an integral part of Dayton and its main role is to serve as a supernational protector of human rights, constitutional implementation and reform, and to attempt to control corruption and corrupt practices. The High Representative has the authority to remove elected and non-elected officials from public office, ban them from participating in the public realm in the future, either for definite or indefinite periods, and to directly impose laws it has prepared.

In recent years, the OHR has been trying to reduce its intrusiveness into Bosnian affairs, but continuing political, ethnic, and social non-violent conflict and a lack of movement among the national parties, has led to the recent decision to extend the High Representative's mandate a further year, to June 30, 2008.

Addressing the post-conflict fiscal challenges

At the end of the war, in December 1995, Bosnia and Herzegovina faced many fiscal challenges. Before the war, BiH was part of the Yugoslav Federation and its fiscal institutions, although supposedly republic-based, were actually subunits of the Yugoslav institutions headquartered in Belgrade, the capital of the Republic of Serbia and the political center of the Yugoslav Federation. Following the war, with BiH carved up into Entities as a result of the Dayton Agreement, each Entity gained its own government with considerable autonomy; this later became the means of operating in Brčko District, too, thereby *de facto* leaving this small country as a federation of three separate and fairly autonomous regions. Each of these regions (Entities and Brčko) was authorized in the Dayton Agreement to establish and collect its own domestic taxes, including income taxes, excises, sales tax, labor taxes, and all other taxes on domestic earnings, wealth, production, and consumption.

Dayton put the authority to establish taxes on international trade at the level of the "State." The State in BiH is what would normally be considered central government in other countries, but is actually weaker and smaller than the two Entity governments, with fewer fiscal instruments and competencies. Almost every step to strengthen the State has been resisted by politicians in the Entities, especially in the Republika Srpska and in the Herzegovina part of the Federation of BiH. A strengthened State is usually seen as a weakening of the autonomy and authority of ethnic Bosnian-Croats and Bosnian-Serbs, while it is seen by many in BiH as strengthening the political and economic influence of ethnic Bosniaks. On the other hand, the International Community has been very keen to strengthen the powers and authorities of the State and this is often a component of any discussions related to entry of BiH into the European Union.

As an outcrop of the Dayton Agreement, the International Community has played a very interventionist role in running post-war BiH and in establishing fiscal management capabilities. In the first few years after the war, the EU focused its assistance on running the customs operations, tracking down smugglers, and assisting the nascent tax administrations to chase after tax criminals. The OHR actually imposed legislation that bound all levels of government. It was the High Representative, for instance, that imposed some of the legislation required to complete the closure of the payment bureaus throughout BiH, as well as other legislation governing banking and financial sector regulation, customs policy and other indirect taxes.

Eliminating the payment bureaus[16]

Prior to the disintegration of Yugoslavia, a single Payment Bureau was responsible for all payment transactions in the country. All companies and individuals were required to keep their money on deposit with the Payment Bureau and almost all legal transactions between companies, with government and among government entities, took place within the Payment Bureau. Businesses were required to deposit almost all of their cash at the end of each day and would request permis-

[16] Much of this section is drawn from USAID (2004).

sion to withdraw their cash the next morning. Each deposit and withdrawal was subject to a fee. Payments by one business to other businesses or to government were made as payment orders via the Payment Bureau, which again charged a fee for each transaction.

The Payment Bureau also played the role of the Yugoslav Government treasury system. It took in monies for the government, such as the payment of fees and taxes, allocated those monies to the different levels of government in accordance with specific revenue sharing rules and transfer systems, and made budgetary outlays in accordance with the annual budget and ministerial requests.

Since all monies were supposed to be held in deposits with the Payment Bureau, taxes could be directly deducted from firms' accounts. Since most of the firms in the country were public enterprises, tax payment was mostly an accounting entry. Tax enforcement was simple and the Public Revenues Department mainly occupied itself with the administrative aspects of taxation, such as the storage of forms and the calculation of tax assessments. Enforcement and audit were not important functions.

Suffice it to say that the payment bureaus were neither transparent nor were they conducive to establishing modern financial systems that would help foster market-oriented, private-sector led economic growth and development. However, eliminating these payment bureaus would necessitate creating new public sector treasury systems, with obvious implications for tax administration.

Beginning in 1998, USAID, in coordination with other donors, began the technical work to eliminate BiH's three payment bureaus and to replace them with a modern, functioning government treasury system and a "normal" banking system framework. USAID and the US Treasury (UST) studied the functions of the payment bureaus, developed a plan for the allocation of legitimate payment bureau functions that could be implemented by "normal" institutions, and devised plans to create or strengthen these institutions and develop their capacity to take on these new functions. This plan, which called for the elimination of the payment bureaus by December 31, 2000, was endorsed by the Peace Implementation Council at their meeting in Madrid, Spain in December 1998, providing the political endorsement needed to dismantle this key, communist era institution.

USAID's related assistance focused on two areas: creating the institutional and operational framework for a modern, commercial banking system and replacing the government treasury role that had been played by the payment bureaus with one that would be managed by governments, but leveraging the private commercial banking sector.

US and International Community efforts to eliminate the payment bureaus reached an apex on January 5, 2001 when all the payment bureaus stopped processing payment orders and commercial banks took over this operation in its entirety. With USAID assistance, the Central Bank of Bosnia and Herzegovina opened a new bulk payments clearinghouse that allows commercial banks to provide payment services directly to their customers. Two clearing mechanisms are now operating: a large value clearing and settlement system and a clearing house for small value payments, both of which are now settled through transfers of bank reserves at the Central Bank.

Receipts management

To ensure that government revenues would be channeled to the appropriate jurisdictions—the State, the two Entities, Brčko, ten Cantons, and the more than 120 municipalities—US advisors designed the payment order forms and issued instructions to direct revenue flows through the banking system to the appropriate government coffers. USAID provided the hardware and software that form the backbone of what is known as the Revenue Allocation System (RAS) for directing these flows to the proper accounts. The RAS automatically channels all receipts immediately from bank accounts of taxpayers, based upon their authorized payment orders, with the correct taxpayer, tax type, and other information (this is still far from flawless), and then transfers the monies to the appropriate account of government, be it an Entity-level Government account, Canton or Municipality. The RAS also allocates funds directly from payment order transfers to the specific extra-budgetary accounts, such as the health fund or public pensions.

The RAS did not have the impact on government receipts as was the case in El Salvador (see El Salvador chapter of this paper), since this was already a function of the pre-existing payments bureaus. Nevertheless, it did provide part of the solution to eliminating the payment bureaus, and provided an important foundation for establishing a solid public treasury system. It also laid the groundwork for tax administration that had to work in a more "normal" market-oriented economy—one that could not simply dip into the accounts of firms to collect what it had determined would be the appropriate tax payment.

Expenditure control and management

As the dismantling of the payment bureaus became a near reality, the various governments of BiH realized that they would have to create more normal treasury functions or they would simply collapse. Hence, elimination of the payment bureaus not only necessitated the establishment of a government treasury function, it also pointed up the urgent need to have this happen without delay.

With strong Entity-government support, USAID assistance developed and installed a new Integrated Financial Management Information System (IFMIS), which was installed and activated in both Entities, Brčko District and all ten of the Federation's Cantonal governments between 2002 and 2004. The IFMIS covers the following key processes of the treasury and accounting systems:

- Accounts receivables
- Accounts payables
- General ledger
- Cash management, and
- Purchasing

None of these processes had been automated prior to USAID assistance, nor were they part of an integrated system. The new IFMIS centralized financial management of each of the 13 Entity and cantonal governments in their own, separate treasury organizations within the respective ministries of finance.

A modern treasury system is now in place in the Federation, the Republika Srpska, and in the Federation's cantonal governments. Cash management has improved and non-budgeted expenses have been squelched. Some observers and participants from the time maintain that implementing the IFMIS had an important impact as evinced by immediate improvements in fiscal balances. For example, in the first year of operation, the Republika Srpska as well as all of the cantons that had installed the IFMIS registered revenue surpluses for the first time. Those cantons without the IFMIS continued to run large deficits.

Tax administration

Immediately after the signing of the Dayton Peace Accords, the European Union began providing assistance to the new Entity governments in the enforcement of tax laws, particularly against the smuggling of goods across the borders and in tax fraud related to the various sales taxes in the different areas of the country. Most EU assistance was provided through the EU Customs and Fiscal Assistance Office (EU-CAFAO). CAFAO provided most of its assistance to the nascent tax administrations in setting up and running their "large traders units." EU-CAFAO assistance mainly focused on audit and fraud detection, intelligence and enforced collections.

US Treasury began assisting the nascent Entity and Brčko tax administrations in the late 1990s and focused mainly on strategic planning and leadership training, but most importantly on the design of the overall organizations, established on a functional basis. US Treasury advisors also provided broader technical advisory services to the Directors of the new tax administrations and developed the technical specifications for a USAID program to modernize these tax administrations. USAID assistance began in late 2001 and was initially focused solely on the modernization of tax administration, but specifically endeavored not to overlap the efforts of EU-CAFAO. USAID advisors, working closely with UST advisors, designed and helped implement a new taxpayer identification numbering system and a centralized taxpayer registry, wiping our incorrect and fraudulent taxpayers from the old rolls. USAID advisors designed and implemented a new system for handling tax declaration entry, based on electronic imaging, which swiftly eliminated a backlog of declarations more than a year old. USAID advisors developed and implemented new taxpayer notification systems, taxpayer accounts, tax payment accounting, as well as several other core processes of these tax administrations. The USAID project also assisted almost all tax administration employees in the application of all the newly designed and automated processes. One of the most innovative aspects of the USAID project was the unification of data-communications systems for tax administration throughout the country.[17]

Originally, the USAID program did not provide assistance in audit and enforcement activities, as these were the domain of EU-CAFAO. Later, as EU-CAFAO moved to working nearly exclusively in the set up of the new Indirect Tax Authority (ITA) and was less and less involved with the Entity and Brčko tax administrations, the USAID advisory program began to pay some attention to audit and especially automated audit selection systems.

EU-CAFAO and USAID advisors worked well in parallel to each other, but taking rather different approaches. The result has been considerable progress in the modernization of these tax administrations and the payoff has been in marked improvements in taxpayer compliance and revenues that, until 2005, had been growing at three times the rate of economic growth.[18]

Indirect taxes reform

Until 2004, interest in tax policy among the International Community had been limited to a focus on indirect taxation. The international community's approach did not include tax policy analysis, assessment of the overall tax system, nor development of analytic capabilities among government counterparts. Instead, all International Community focus had been on the very important area of consolidating and rationalizing the entire system of indirect taxes.

The International Community had to spend some effort in convincing counterparts that they should support these reforms, but the weight of the OHR was very much apparent throughout all these discussions and the Indirect Tax Commission was established by OHR *decision* (same as fiat). The Indirect Tax Commission included representatives of the two Entity governments, the State Government (i.e., republic level) and the government of the District of Brčko, as well as a number of expatriate *ex officio* and supporting members. The Indirect Tax Commission was chaired by an expatriate, appointed in the same OHR Decision. The mandate of the Indirect Tax Commission was to consolidate all indirect taxes with the same rates prevalent around the country, eliminate the sales taxes, and implement a Value-Added Tax (VAT). All these new taxes would be administered by a new authority called the Indirect Tax Authority (ITA), which was to belong to the Entities, Brčko and the State. The ITA began operations in January 2005.

As mentioned, the OHR had imposed a number of laws related to the BiH fiscal system, and it also heavily influenced governments to enact legislation and agreements that it required, such as the VAT, which was enacted by the State-level parliament, but could only take effect based on agreements with the Entity and Brčko govern-

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17 See Rozner and Gallagher (2006) for complete details of the USAID Tax Modernization Project.

18 See Rozner et al. (2005) for a discussion of the revenue performance as it related to USAID and EU assistance.

ments.[19] Despite the willingness of the OHR to intervene in this way, its interventions in the tax area were mostly limited to indirect taxation and the rationale for this was that direct tax reform was not a requirement for accession to the EU. The VAT took effect on January 1, 2006, a decade after Dayton. This delay, in part, was due to the fact that taxation was specifically assigned as a responsibility of the Entities in the Dayton Agreement, and since few people felt that the Entities should separately issue their own VATs, it was necessary to negotiate, compromise, and come to an agreement between the Entities and Brčko to establish the VAT. This took almost ten years.

Table 4 shows only moderate growth in overall taxation in BiH during the period 2004 to 2005, but this overall table is misleading. The reader must keep in mind that during this period, import duties were being slashed. Also, USAID's Tax Modernization Project (TAMP) specifically only sought to strengthen the Entity and Brčko tax administrations and only helped to strengthen the ability of these offices to administer *domestic* taxes. Import taxation was outside USAID-TAMP's scope.[20]

USAID's focus was domestic taxation, as well as the collection of social contributions. Table 4 shows rather impressive performance in improving the collection of these taxes in the Federation and in the Republika Srpska. Revenue performance was markedly weaker in Brčko District, but this is mainly due to other factors, such as the harmonization of excise duties, especially at import. Data for 2006 are only partial, but early indications are that domestic taxation and social contributions have continued rapid growth, while the newly implemented VAT has surpassed all expectations in terms of revenues.

TABLE 4: REVENUE GROWTH IN BIH IN 2004 AND 2005

	2004	2005
Taxes		
Federation	5.6%	5.8%
RS	6.1%	13.2%
Brcko	-0.5%	-11.2%
Social contributions		
Federation	8.4%	6.7%
RS	1.8%	-0.4%
Brcko	25.2%	20.2%
Domestic Tax + Social Contributions		
Federation	22.7%	13.0%
RS	7.9%	11.1%
Brcko	6.0%	-6.3%
Import duties		
Federation	-47.0%	NA
RS	-24.5%	NA
Brcko	-29.4%	NA

Data from Central Bank of Bosnia and Herzegovina
Estimates of the domestic tax take for 2005 by author.

Tax policy analysis and capacity building

For years, the international community, including USAID and UST, had shown little interest in broader tax policy reform. Yet in early 2004, USAID commissioned a report that exposed disturbing findings about the tax system.[21] The report revealed that uncoordinated and poorly designed tax policies placed heavy burdens on labor and business and distorted economic decision-making. The institutional setup in each Entity also led to a plethora of tax rates and tax bases, complicating compliance and belying the notion of creating a "single economic space." The report and subsequent discussion between the International Community and BiH counterparts sparked new interest in a direct tax reform agenda. To help accelerate direct tax reform, USAID-TAMP quickly took the lead in guiding the income tax reforms in the two Entities, despite the early role of Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ), which had supported

19 The Dayton Agreement put taxation authority at the Entity rather than the State level.

20 The project was originally called Tax Administration Modernization Project (TAMP), but when its scope was widened to include tax policy reform and fiscal analysis in 2004, the name was changed to simply Tax Modernization Project, retaining the abbreviation TAMP.

21 See Gallagher with Bosnic (2004).

the enactment of a new income tax law in Brčko District in 2003. In August 2004, USAID-TAMP changed its name to Tax Modernization Project, dropping the "Administration" to show the broader aims of the project to include tax policy and capacity building.

To present a single, coherent reform agenda to BiH authorities, the International Community established a Direct Tax Commission (DTC). The DTC included representatives of USAID, UST, US State Department, OHR, GTZ, German Foreign Ministry, IMF, World Bank, and EU-CAFAO. The International Community decided that it would support direct tax reform but it would not seek to impose such reform. This then initiated efforts at helping to build analytic capabilities in the respective ministries of finance. Assistance in this area only began in early 2005, and continues today and includes both economic/financial and legal analysis of a variety of concerns, such as personal income and corporate taxation, pension reform, and property taxation.

Gallagher with Bosnic (2004) showed that nominal tax rates were excessive. The tax wedge on labor was, and remains, outrageously high, mainly due to a bankrupt public pension and provision system, and the taxes on business were irksome if not financially burdensome.[22] Indeed, in an informal survey of small businesses, only one business owner claimed to have actually paid the tax due; this business had to close its doors, in part because of the difficulties created by the tax system.

There were essentially two root causes of these problems with tax policy: On the one hand, these taxes were all enacted under the socialist system of the Yugoslav Federation, and simply were not consistent with modern market principles. On the other hand, the creation of the numerous jurisdictions (State, Entities, Cantons, Brčko District, and Municipalities) allowed that not only were these antiquated taxes to be imposed on the poor people of BiH, but also that they would be imposed differently in each jurisdiction. For instance, the recently enacted, global personal income tax in Republika Srpska replaced seven different taxes on personal income. The parallel reform proposal in the Federation of Bosnia and Herzegovina would replace about 70 different personal income taxes.[23]

Milan Zoric, a former employee of a State-Owned Enterprise, established a company that sells carpeting and flooring to businesses. The company has four employees, including Milan.

Milan's biggest problems in doing business in BiH, according to his own ranking, include: a lack of business ethics among Bosnians, difficulty in getting customers to pay on time, difficulty in getting goods and services from clients on time, especially from state-owned enterprises. Milan has established a very good reputation of being able to meet contract terms and get his goods delivered on time.

When asked about the burden of taxes, fees, and tax inspections on his business, Milan was hesitant. He clearly felt that these were secondary or tertiary to the problems already mentioned. When pressed however, he admitted that he would never be able to remain in business if he actually paid the taxes on wages as specified in the law. Milan's employees officially receive the minimum wage, though their per diems and other "perks" make their take-home packet several multiples of this. The tax inspectors know and acquiesce in this subterfuge. They know that no businesses can afford to pay these wage taxes. Milan did not complain about the tax inspectors, indeed, he says they seem to really know what they are doing and do not mistreat him. Milan feels that in part this is because he is not a "fat fish" and keeps under the radar by remaining small. Milan also mentioned that it took two months to get his company registered.

[22] The tax wedge is the difference between the average worker's net pay and the total costs of employing them, including income taxes and social-security contributions.

[23] Prior to Gallagher with Bosnic (2004) none of these taxes had actually been studied as part of a system. Indeed, it was not until early 2004 that these separate tax laws had been translated into English or German, despite the fact that it was USAID and GTZ that were taking the lead in direct tax administration and policy reform.

In close coordination with the broader International Community, USAID's tax policy advisory team helped Ministry of Finance counterparts in the Republika Srpska and the Federation draft new Entity personal income tax and corporate income tax laws and regulations. They developed micro-simulation models to estimate the impact of policy alternatives on revenues and the distribution of the tax burden.

They also worked side-by-side with Ministry of Finance counterparts to ensure their understanding of the reform options. The team provided formal and on-the-job training to educate counterparts in the basic principles of tax policy and to explain the implications of the various reform alternatives on the table. USAID-TAMP advisors also participated in public forums to discuss the impact of the new laws with representatives of business and labor, and assisted counterparts in preparing presentations on the reform proposals to parliamentarians and other government bodies. As of this writing, the major direct tax reforms have been enacted in the RS and Brčko, but await enactment and then implementation in the Federation. Future major direct tax reform that is anticipated is the reform of the taxes on real estate. There has been considerable discussion and planning, but to date, no new legislation has been enacted.

Other fiscal strengthening assistance

There is a great paradox in BiH. Its currency is directly tied to the Euro via the currency board, which necessitates considerable fiscal control, coordination and stability. Yet, the odd structure of the BiH state as established in the Dayton Agreement makes this coordination extremely difficult. The State level of Government cannot impose financing strictures on the other parts of government, and intergovernmental transfers to cover cash flow problems are not tenable. The role of fiscal oversight has been played directly by the IMF. It is the IMF that imposes fiscal balance on each level or section of government.

While the IMF attempts this role, it has had to execute this power with very little good data. The problem is that until recently, the data were not consolidated by one governmental unit responsible for overall macroeconomic reporting and policy making; no such unit actually existed. In 2005, however, the Council of Ministers established a law for the creation of the BiH Fiscal Unit. The Fiscal Unit now has the task of consolidating all fiscal data, from Municipal, to Entity, to State levels. The IMF helped set up this unit, and it works as part of the Macroeconomic Analysis Unit of the Indirect Tax Authority.

It was not until almost a decade after the signing of the Dayton Peace Accords, in 2004, that the EU began to provide assistance to the Entity and State-level governments in budget planning and preparation. Since the IMF essentially was supervising these budgets, along with input from the rest of the International Community, perhaps the inability to plan and budget was not too crucial. In 2004, the World Bank began to provide assistance in development of a Medium Term Fiscal Framework, but in the absence of a clear set of counterparts, and based on extremely weak data compilation, it is not clear how this MTFF will contribute to macro-fiscal planning and monitoring.

At the local level, USAID and the Swedish International Development Agency (SIDA) have jointly provided assistance to municipal governments in both Entities in a variety of areas, including in maintaining a set of fiscal accounts based on normal government finance rules. This work builds upon the treasury system assistance that USAID provided years earlier.

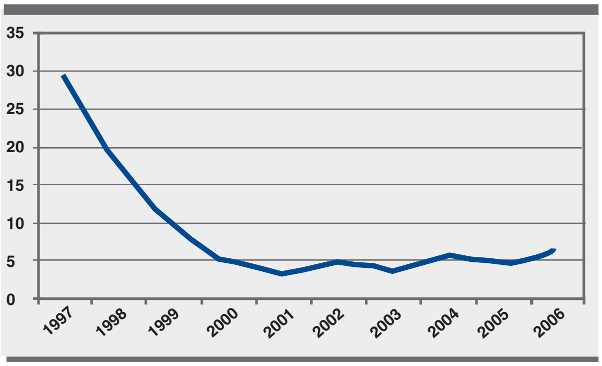
USAID has been providing assistance in developing legislation and regulations for real estate taxation, as well as providing analytical tools for designing the system for and undertaking mass appraisal. This tax would be implemented at the local level in the Entities, but with Entity-level tax administration support and supervision. Brčko District passed the real estate tax legislation in July 2007, and full implementation is to begin in January 2009. USAID will provide assistance in the implementation of the real estate tax.

Outlook

It is clear from Figure 4 that economic growth right after the war was robust, this mainly due to rapid and large donor inflows, and resumption of economic activity after the war and some refugee and IDP returns. Over the past decade, per capita income has nearly tripled, from about $3,140 in international purchasing power parity terms, to about $8,540 in 2006. Yet, despite this recovery in GDP, jobs have not grown apace and unemployment, though data are scanty, is considered by all observers to be quite high.

The double-digit rates of economic growth had entirely petered out by the year 2000 and the economy is now growing at what can be considered much more "normal" growth rates, or around 5% per year.

FIGURE 4: ECONOMIC GROWTH RATES IN BOSNIA AND HERZEGOVINA[24]



Despite the rapid growth rates immediately following the end of armed conflict, living standards in BiH simply have not returned to pre-war conditions. Unemployment, both official and unofficial, remains high and the purchasing power of everyday salaries is low.

[24] Data are from World Economic Outlook database, April 2007.

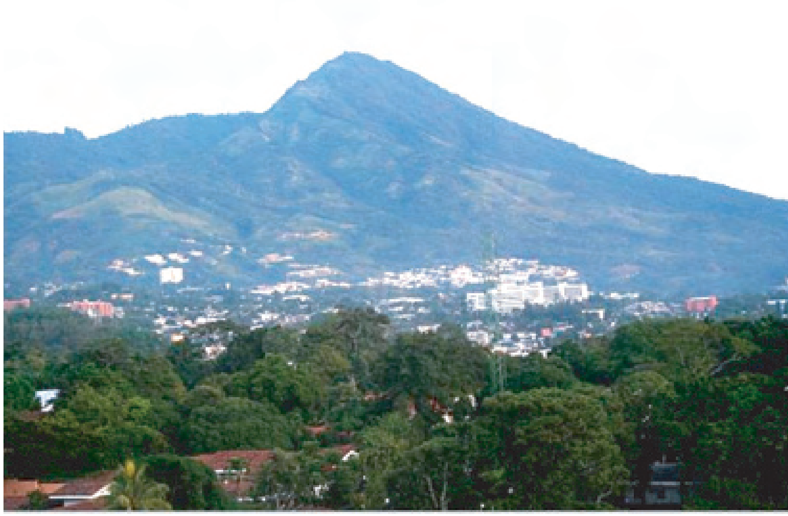
5 EL SALVADOR

Nature of the conflict

After 12 years of intensive civil war, pitting leftist guerrillas against various governments based on an oligarchic structure of powerful elites, El Salvador's peace accords were signed in Chapultapec, Mexico, in February 1992. With intermediation of the United Nations, and in particular Mr. Oscar Arias, former president of Costa Rica and now a Nobel Laureate, a number of agreements were signed between the rebels and the government. The Farabundo Marti National Liberation Front (FMLN), then the rebel guerrilla organization, converted itself into a legal political party and participated in future elections. The FMLN continues to participate in the electoral process and is the second most popular party in the country. Indeed, there are several FMLN Deputies in the National Assembly, many FMLN mayors, and even the mayor of San Salvador was affiliated with the FMLN.

The civil war in El Salvador was ideological at its roots. In many ways, the war was a reaction to the long-term domination of the economy by a small group of families, as well as a response to repressive government and a brutal military that was used to crush most forms of civil unrest and protest. Leftist guerrillas were supported by outside sources, especially Cuba, while the US Government provided both military assistance to the army, and economic assistance to keep the economy from crashing down.

All wars are dirty, but the Salvadoran war was particularly so. Death squads supported by some of the richest families of the country committed targeted murders as well as contained massacres. One of the most famous such murders was that of Bishop Oscar Romero in 1980, which fanned the flames of the conflict. Romero's crime was his advocacy for the poor, which in the El Salvador of the time was considered counter to the order of the day. Romero's and other such assassinations led to widespread disaffection of many people, and the coalescence of leftist groups. It was in January 1981 that the various leftist movements joined to form the FMLN.



San Salvador on the skirt of her volcano

Dirty tactics were not solely the domain of the right. Indeed, the FMLN and related groups also assassinated business and political leaders, extorted "war taxes" from the middle and upper classes, and "conscripted" the sons of rural families against their will.

These and the events that ensued shaped the political landscape that exists still today in El Salvador. The orthodox leadership of the FMLN, following its intellectual leader Mr. Shafik Handal, can quite clearly be characterized as communist and committed to the type of governance systems found in Eastern Europe. On the opposite side is the National Republican Action party (ARENA), generally classified as rightist or "neo-liberal", which has been the main counter to the FMLN since the second half of the 1980s.

The human toll of the war was great. Between 1980 and 1992, about 80,000 persons, or about 1.5% of the population, lost their lives in war. War also sparked mass migration to the capital city, San Salvador, or out of the country, mostly to the United States—a flow that continues to this day. At the same time, economic infrastructure was under constant attack, with almost all bridges in the country being destroyed and replaced by the US Army with temporary "bailey bridges", and the electrical system and other basic utilities also subject to constant sabotage.

Figure 7 (at the end of this chapter) shows the poor performance of the economy during the war: in particular, during the first years of the 1980s, the economy actually was in contraction. Only massive inflows of economic assistance from the United States were able to stem this decline and bring about at least some growth during the rest of the period, albeit below the rate of population growth. Obviously, poverty was increasing throughout this war period.

Addressing the post-conflict fiscal challenges

Peace in El Salvador has brought about a number of steps to improve the economy, mostly because of ARENA's domination of the legislature and executive branches of government. Meanwhile, many observers feel that the counterbalance of the FMLN in the political system has helped push the government toward more pro-poor policies, introducing a greater sense of social responsibility in government programs and policies.

The international community, especially the United States and the United Nations, has played an important role in helping to implement the country's peace accords and to bring about national reconstruction. Rebuilding bridges, electrical structures, and other infrastructure, along with the integration of former combatants into mainstream peaceful lives, was mostly funded by USAID, although other donors also provided considerable assistance. The United Nations provided a large contingent of observers, referred to as the UN Observer Mission to El Salvador (ONUSAL), to ensure that peace took hold and that particular aspects of the accords, such as a complete restructuring of the national police, were fully implemented. ONUSAL's contingent was about 1,000 persons strong, comprising military, police, and civilian observers. ONUSAL's mission lasted from July 1991 to September 1995.

Post-war El Salvador is very different from pre-war El Salvador in that the political process is much more open, elections are free and fair, and all sectors of society are actively participating. The party that was ruling the central government for the last few years of the war is still running the country, but now the former rebels sit beside them in the legislature and in the town halls.

During the war years of the 1980s, USAID provided considerable financial and technical support to a number of political, social, and economic think tanks in the country. Prominent among these was the Salvadoran Social-Economic Development Foundation (FUSADES by its Spanish acronym). FUSADES carried out a number of functions. Of most significance for this study was that it essentially developed the economic reform agenda that ARENA presidential candidate Alfredo Cristiani adopted as his own in the 1989 elections.

FUSADES developed the agenda, sponsored numerous workshops and participated in media dissemination of its studies, findings, and conclusions and marketed its overall reform agenda to the public. When President Cristiani took office late in 1989, the new reform agenda was set. It was not until a few years later, after overcoming the shock of the 1989 FMLN offensive on San Salvador, that the reforms would actually begin. However, by 1992, the fiscal aspects of this reform agenda were put into full swing.

The demand for fiscal reform immediately after the cessation of conflict in 1992 was focused on establishing a tax system that would encourage private sector-led economic development and growth, while also providing sufficient resources to meet many of the county's looming social concerns, but particularly to defray the costs of national reconstruction and reintegration of ex-combatants. At the same time, the ruling ARENA party wanted to impose greater control over its public expenditure management systems, unifying its capital and current budgets and implementing an Integrated Financial Management Information System (SAFI).

Massive aid flows, particularly from the US, meant that El Salvador could focus its fiscal reforms on expenditure control and accountability and raising revenues while fostering a market-oriented economy.

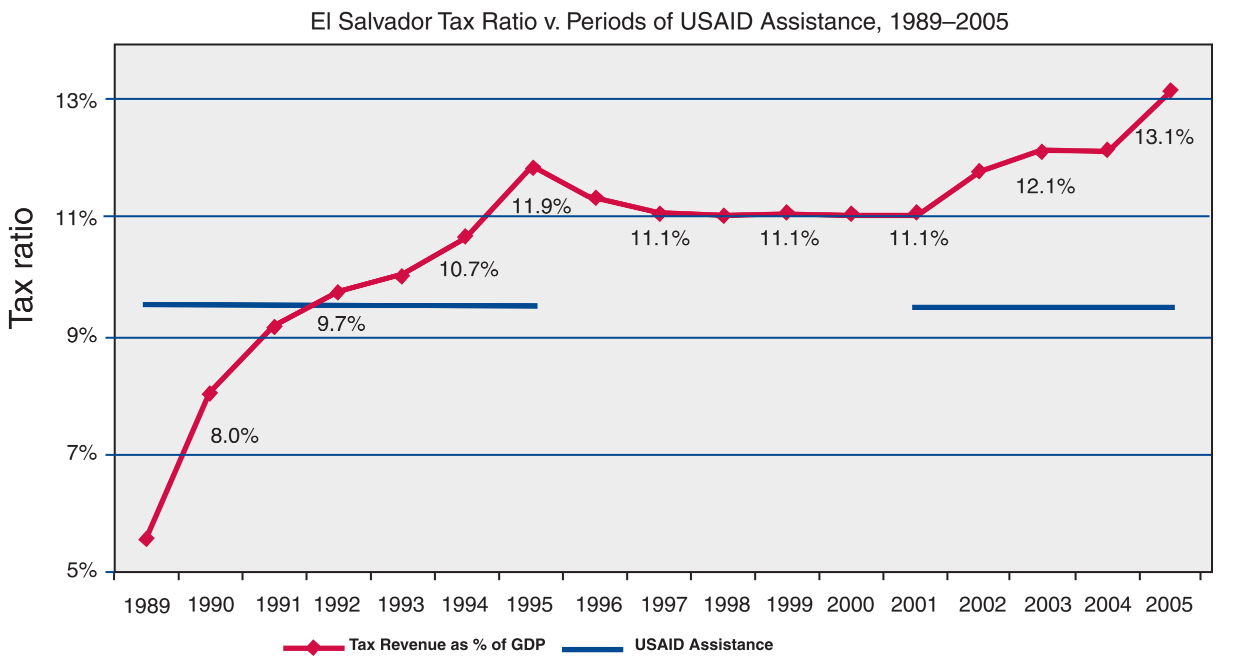
Taxation

USAID provided considerable assistance to El Salvador in the modernization of its tax system, spanning from the end of 1991 (just before the end of the civil war) to mid-1995. Assistance covered areas such as tax policy analysis, tax policy reform, streamlining and automating tax and customs administration, and training in all aspects of tax and customs administration. The result was the creation of a modern tax structure, with competitive tax rates, improved compliance rates, and reduced fraud and corruption.[25]

Specific actions taken to modernize the tax system include both policy and tax administration modernization. On the policy side, the Government of El Salvador repealed a series of antiquated taxes, such as stamp taxes on legal documents and on all sorts of sales invoices, essentially an outmoded sales or "turnover" tax. The sales tax was collected at both the retail and wholesale levels and led to what is known as the "cascade" effect, where tax is piled on tax, distorting economic behavior and giving incentive and opportunity for fraud. In place of these outmoded taxes, the Government introduced a modern Value-Added Tax (VAT), with very few exemptions and at a relatively low rate of only 12%. At the same time, income taxes, for both individuals and companies, were rationalized, reducing many exemptions and special treatments and putting in a maximum rate of 25%. The earlier corporate income tax had multiple rates, whereas the new law imposes only the single rate of 25% on corporate profits. Personal income tax is progressive and its reform included the introduction of a withholding tax on salaries.

A very important part of the reform of 1992 and 1993 was the reduction of dispersion in the import duty tariff and the reduction in maximum

FIGURE 5: TAX RATIO IN EL SALVADOR AND US ASSISTANCE IN TAX MODERNIZATION[26]



[25] See USAID (2006a).

[26] Figure taken directly from USAID (2006a).

rates of about 200% to 35% and then 20%. At the same time, zero rates on many input and capital goods were raised to 5%. Subsequently, after 1995, top tariff rates were further decreased and the import duty on many goods considered to be inputs or capital goods were reduced again to zero. Cutting tariff rates in 1996 led to the decline in the overall tax ratio in this and subsequent years, as shown in Figure 5.

USAID assistance was critical in this reform. USAID-funded advisors drafted the VAT law, based in large part on reforms taken in Chile, and provided analytical and quantitative support to the reform of the income tax laws. USAID advisors also helped to "market" these reforms, helping to fashion the messages that would be delivered to the public and to assist in dialogue between government and the National Assembly (parliament) as well as with civil society.

USAID advisors provided assistance in tax administration modernization. This included developing a new, clean, taxpayer registry with an intelligent taxpayer identification number (TIN), centralized taxpayer database, risk-based audit selection system, audit case management systems, customs database development, and IT reforms, all coupled with considerable training, as well as materials, such as computers. A USAID advisor helped bring about the single most visible reform to customs, the placement of a traffic signal in the airport for the semi-random selection of passengers for inspection purposes.

These reforms helped raise the ability of the tax administration to enforce tax laws, led to increased compliance, and reduced fraud, and with lower rates and fewer taxes, it led to increased revenue for the fisc.

Receipts management

At the end of conflict, in 1992, El Salvador's Ministry of Finance found itself inheritor of an antiquated system for managing its fiscal receipts. On the one hand, the Ministry's Treasury Department ran a number of collection offices that directly received tax and other payments from taxpayers and others doing business with the Government. Most receipts, however, were handled by the banking sector. Most of the country's private banking sector had been nationalized in the 1980s, but as civil conflict wound down and peace was ushered in, these nationalized banks were privatized and once again began operating in the private sector.

Taxpayers and others would bring their tax declarations to the banks, make payments to the banks, and receive a receipt for these payments. The bank would usually hold the receipts for a period of 45 to 60 days before making these funds available by crediting the Government's account. The banks passed all the tax declarations, copies of payment receipts, and bank statements to the Treasury. Treasury was then responsible for reconciling all these receipts, bank credits and balances, and for ensuring that the correct taxpayer was given credit with the Treasury and with the Tax Administration. Investigations showed that these accounts and documents had not been reconciled in years. Indeed, it was essentially impossible to reconcile these accounts; taxpayers could not be certain that the fisc had ever received the tax payment. The only thing that was certain, was that government coffers were, at a minimum, 45 days behind the actual time of payment made by the taxpayer.

USAID technical advisors designed a system based on commercial "point of sale" devices, such as are used to swipe credit cards, to capture tax payments made in the commercial banks. These point of sales devices captured all relevant tax payment information, including taxpayer identification, type of tax, amount, location of payment bank, date of transaction and fines and other charges. The form was now available in electronic form and was downloadable by telephone modem each night, or by backup exchange of memory chips. For the first time on record, the Treasury could reconcile bank accounts with taxpayer payments, and the tax administration could appropriately credit taxpayers with the proper tax payments.

USAID paid for the purchase of a number of these point of sale devices as a pilot project. Once the pilot project was implemented and evaluated and demonstrated to the commercial banks, the banks signed up to purchase their own point of sales devices so that they would then be eligible to take tax receipts on behalf of Treasury. At the same time, banks were paid a nominal fee—less than one US dollar—per transaction while their own paperwork was greatly reduced, but were now required to make the tax receipts immediately available to the Government. This one measure alone, contributed to a one-time reduction in the Government's fiscal deficit by advancing its cash flow receipts by a full 45 days in 1993.

Expenditure control and budgeting

In 1993, USAID began a program of assistance, in coordination with the Inter-American Development Bank (IDB) and the IMF, to implement a comprehensive Integrated Financial Management Information System covering budget preparation, accounting, treasury, debt management, and audit for all government sector transactions. The Integrated Financial Management Information System project, known by its Spanish-language acronym, SAFI, introduced performance-based budgeting, decentralized budget execution within a unified treasury system, control over fiscal transactions, and enhanced spending on social sectors while freezing, in nominal terms, military spending.

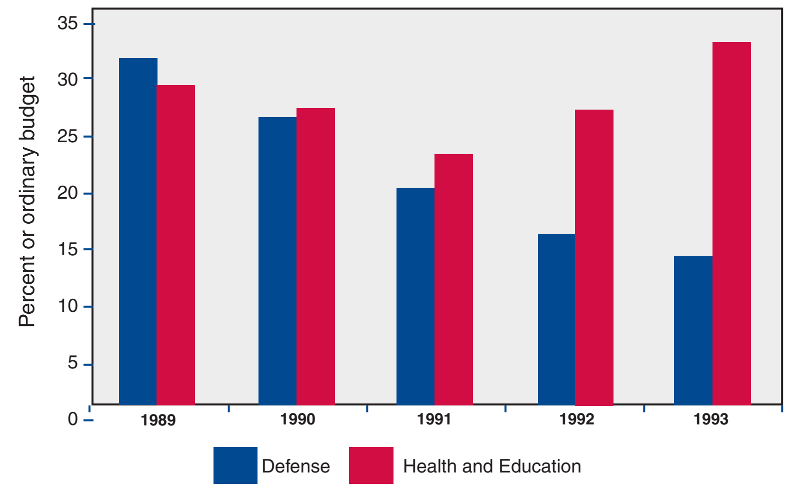
El Salvador has done much to strengthen its fiscal system and the assistance of the international community has been essential. The Salvadorans have kept the lid on their fiscal situation, with modest fiscal deficits and, in recent years, declining debt-to-GDP ratio. The overall macroeconomic situation is rated highly by the World Economic Forum, but government revenues are still quite low compared to the public needs of Salvadoran society.

The IMF (2005b) in its report on fiscal transparency and public expenditure management system praises the progress made in accounting, audit, budget, treasury and other areas, while making a few recommendations, such as extending the SAFI to local governments and clarifying intergovernmental fiscal relations.

Peace dividend

Starting towards the end of the civil war, the government froze, in nominal terms, defense spending. In the context of slowly increasing revenues, this allowed for a decline in defense spending as a percent of the "ordinary budget," i.e., all current spending excluding spending on interest payments. At the final cessation of hostilities, the government continued the freeze on defense spending while beginning to ramp up social spending, particularly in the areas of health and education. The "peace dividend" and its application to social spending, directly after the end of the armed conflict, is most clearly demonstrated in the following graph.

FIGURE 6: EL SALVADOR'S PEACE DIVIDEND[27]



[27] Adapted from Gallagher (1995b).

The following table demonstrates clearly the increasing resources the Government of El Salvador began to dedicate to social spending during the immediate post-conflict years.

TABLE 5: SOCIAL SPENDING* IN EL SALVADOR

	1994/95	1998/99	2000/01
Per capita spending in 1990 dollars	98	122	158
Percent of GDP	5.3	6.4	8.1
Percent of total public spending	36.9	48.9	59.6

*Social spending includes spending on education, health and nutrition, social security and welfare, housing and some community services.

There remains much to do, however. Social conditions have improved somewhat in the country, but indicators such as life expectancy, adult illiteracy, and school enrollments, while better than before the peace, are still worse than in most of Latin America, though no worse than most of the other countries of Central America.[28] (For a comparison of social indicators in Central America, see Table 6 of the next chapter.) Add to this concern for the poorer sectors of the society, the costs of crime and especially organized crime that are imposed on society and business.

By 1995, El Salvador had made considerable advances, but its tax revenues remain at the traditionally low levels of only about 12% of GDP. Although the peace dividend of reduced military spending has been of help in redirecting more budgetary resources to social sectors, to this day, such spending is still woefully inadequate and social progress continues to lag economic growth. Crime seems always to be on the rise and it seems to be getting ever more violent. A new approach to the fiscal system and a reallocation of resources to meet these continuing post-war challenges are needed.

El Salvador has not been able to keep up with its social services needs and the soaring public insecurity. The government has been able to raise its tax take as percent of GDP a little over the past few years, and the structure of public spending has improved in the sense that there is much less devoted to the military and more devoted to social services, especially elementary and secondary education and to basic health care. However, there are ever increasing demands for greater and better spending on public security and the administration of justice. This expanded need for new spending will have to be funded by the tax system.

Social Investment Fund

During the height of the conflict in the 1980s, the US Government helped to establish a special fund that would channel financing to local governments. This fund was essentially a means to support local government in areas where rebels were gaining ground; essentially, it was a counter-insurgency program.

At the end of 1990, the Government of El Salvador created the Fondo de Desarrollo Social (FIS) or Social Investment Fund. The FIS was originally established as a temporary entity that would be able to nimbly and accountably handle donor funds that would be used for projects throughout the country in areas where the Comision Nacional de Restauracion de Areas (CONARA) or National Commission for the Restoration of Areas was not operating. The FIS was established outside the normal functions of government, with financial autonomy and control over its personnel resources. It became known as an institution that handled funds well, developed good, socially beneficial projects, and it was attractive for donors as an implementing partner.

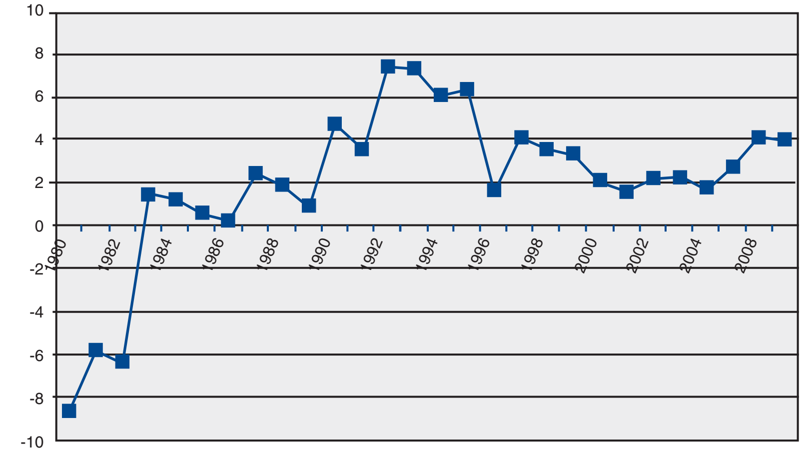
After the war ended, the Government established the Secretaría para la Reconstrucción Nacional (SRN) or National Reconstruction Secretariat. The SRN became the main institution established for implementing the national reconstruction

[28] It is certainly worth pointing out that considerable progress has been made. Between 1992, the end of the war, and 2004, the percentage of Salvadorans living in extreme poverty has halve to 15%, school enrollment rates have increased, and child mortality has dropped from 52 per thousand to 31.

program, very much in parallel to the activities of the FIS. The SRN eventually took over the activities of the CONARA program and folded these into its Municipalidades en Acción (MEA) or Municipalities in Action program.

By 1996, the SRN and the MEA were dismantled and their remaining activities, assets, and responsibilities were folded into the FIS. The name of the FIS was then changed to the Fondo de Inversión Social y Desarrollo Local (FISDL) or the Fund for Social Investment and Local Development. The FISDL continues to operate to this day and continues to attract donor funding from Spain, the US and other bilateral donors.

FIGURE 7: ECONOMIC GROWTH RATES IN EL SALVADOR[29]



Outlook

After rapid deterioration of the economy due to war and sabotage in the early part of the 1980s, the economy started to gain some positive rhythm. In the period immediately after the signing of the Chapultapec Peace Accords (February 1992), the Salvadoran economy really got up a head of steam. Furthermore, there was a "peace dividend" in the sense that resources were no longer devoted to waging war but to rebuilding and recovering.

This multi-year spurt in economic activity came from a number of sources, including: large relief flows to fund reintegration and reconstruction programs, improved private investment in response to improved fiscal and other economic policies of the government, and increased and improved public investment, in part funded by the peace dividend. In addition, there was a relief and a general sense that with peace people could again focus on business activity.

The boom of the early to mid-1990s was temporarily arrested in 1997, but the economy soon again picked up some speed. By 2000, however, even after dollarization of the economy (some might say because of it), the economy seemed lackluster. The earthquake of 2001 put the brakes on growth once again, putting economic activity in many parts of the country on hold while people dug out and began anew the reconstruction of their local markets, homes, and schools. Since then, El Salvador has shown signs that it is ready to begin reaping more of the benefits of its liberalized economy.

[9] Data are from World Economic Outlook database, April 2007.

6 GUATEMALA

Nature of the conflict

After many years of political and social instability, marked by *coups d'état* and countercoups, Guatemala's 36-year civil war began in earnest in 1960, and did not end until the signing of peace accords in 1996.

Four principal left-wing guerrilla groups—the Guerrilla Army of the Poor, the Revolutionary Organization of Armed People, the Rebel Armed Forces, and the Guatemalan Labor Party—conducted economic sabotage and targeted government installations and members of government security forces in armed attacks. These organizations combined to form the Guatemalan National Revolutionary Unity in 1982. At the same time, extreme right-wing groups of self-appointed vigilantes, including the Secret Anti-Communist Army and the White Hand, tortured and murdered students, professionals, and peasants suspected of involvement in leftist activities.[30]

The cost of the war is expressed in the 100,000 lives that were lost in conflict, or about 1.5% of the national population. Add to this the slow rates of growth, and the absolute economic decline in the economy for several years during some of the more conflict-intense years of the early 1980s.[31]

An important root cause of the war in Guatemala was the basic economic and social polarization of the society and the economy. Descendants of European immigrants, known as Creoles, held sway over almost all important economic assets in the country, while the mixed race Guatemalans, known as Ladinos, worked in mainly urban areas and made up most of the blue collar class. Indigenous peoples, who comprise more than half of the country's population, mostly lived in rural areas, operating small, traditional agriculture or providing labor for commercial agriculture.

Mayan temple in Tikal

In this system, the wealthy elite have always been strongly in support of low rates of taxation and government spending. What public spending did occur has focused mainly on urban areas, particularly on Guatemala City.

This situation is not unique to Guatemala; indeed, it is rather prevalent throughout Central America, but it is most pronounced in Guatemala. This tendency has led to particularly low levels of social standards, that are clearly demonstrated in the following table.

[30] This paragraph drawn from http://www.globalsecurity.org/military/world/war/guatemala.htm.

[31] See Figure 8.

TABLE 6: INCOME AND POVERTY IN CENTRAL AMERICA

Country	Income per capita $	Population in poverty Percent	Population in extreme poverty Percent	Illiteracy rate among adults Percent
Nicaragua	461	50	19	32
Honduras	853	53	32	26
Guatemala	1,645	75	58	32
El Salvador	2,016	48	9	22

Sources: Income and illiteracy rates are from the International Labor Organization. Data are from about 2000. Other data from Department for International Development (1999).

TABLE 7: PUBLIC SPENDING IN EDUCATION AND HEALTH IN CENTRAL AMERICA, AS PERCENT OF GDP

	Guatemala	El Salvador	Honduras	Nicaragua	Central America	LAC
	Public Education Spending					
1985	1.5	..	4.0	..	..	3.1
1995	1.7	2.2	3.6	3.1	3.0	3.3
1996	1.6	2.3	..	3.2	3.0	3.3
1997	..	2.5	..	3.7	..	..
1998	2.0	..	4.0	4.2	..	..
	Public Education Spending					
2000	2.0	3.2	3.6	3.4	3.6	3.4

Data are from the International Labor Office

Table 6 shows Guatemala as having the greatest poverty and illiteracy when compared to its Central American neighbors (Costa Rica is not included, but it has much lower poverty and illiteracy rates). What is striking, however, is that Guatemala has attained these low social standards despite having had the second highest level of per capita income.

Table 7 shows that much of this persistent poverty and illiteracy, despite income levels, is also associated with extremely low levels of social spending by the Government, although improving somewhat after the end of the conflict.

Addressing the post-conflict fiscal challenges

Signing the Peace Accords in 1996 did not have the immediate impact on economic growth that it had in the Salvadoran case. There are several reasons for this. First, the Guatemalan economy had already returned to a fairly stable economic growth path several years before the onset of formal peace. Second, the Guatemalan war, while of much longer duration than the Salvadoran war, was always of lower level intensity and resulted in far less economic and human damage and suffering. Third, implementation of the Guatemalan peace accords was relatively less urgent, and the peace dividend less evident, and so the pumping up of the economy that happened immediately after El Salvador's peace accords, did not occur in Guatemala.

From the late 1980s to about 1993, USAID funded technical assistance developed specifically with the intent to strengthen tax policy and tax administration and to raise the overall tax-to-GDP ratio. However, after several years of technical assistance, the Guatemalan treasury found itself with an even lower tax level than when the project began. Gallagher (1995) documented this failed attempt to raise the tax ratio and identified some of the most important reasons. The various governments ruling the country during the period of assistance had different degrees of interest in strengthening the revenue system. The powerful business class, organized by the lobby group called CACIF, was steadfastly against any legal reforms or improved administration or enforcement efforts. The Guatemalan constitution of 1986 goes into sufficient detail to ensure that any policy reforms that groups such as CACIF do not support can easily be categorized as unconstitutional.

Guatemalan taxes remained low, the government was not inclined to borrow to finance deficits, and the cap on government spending was held down to ensure fiscal stability. This conservative approach, while macro-economically sound, meant that little public effort was made to provide services to the public. In particular, social service provision in Guatemala, especially in the countryside where battles were being raged, was dismal at best. Huge gaps in social indicators between rural and urban areas loomed, as did such gaps between Guatemala and almost all comparator countries—namely, countries in the region and countries with similar levels of per capita Gross National Income. Gallagher (2003) clearly presents how ignoring social services and the countryside has led to severe inequality and social suffering.

Fiscal Pact

With peace accords signed in 1996, the country set a new course, where there would be greater participation of all classes and social groups in determining public policy. In 2000, based on several proposals and multiple discussion forums, a group of 161 different organizations, from government, political parties, business organizations, and social service non-governmental organizations (NGOs), signed the country's "Fiscal Pact." That 161 diverse organizations were able to come to an agreement to set out common specific goals and objectives was a true breakthrough in this otherwise deeply polarized society. The specificity and depth of the fiscal targets in the Fiscal Pact pay even greater tribute to the significance of this event and process.

The Fiscal Pact, which received considerable support from international organizations, and especially the United Nations Observer Mission in Guatemala (MINUGUA), included spending increases by Government in a number of social areas, reduction in the military budget, and a target of 12% of GDP as the overall tax ratio.[32]

This participation and clamoring for a seat at the table, coupled with a willingness on the part of consecutive governments to engage with social NGOs and parliamentarians, led to the creation of the Fiscal Pact. The Fiscal Pact led to agreement on a list of overarching policy positions, including raising the tax ratio by over 50% within a few short years. The money was needed to increase social and security spending and reduce disparities between rural and urban areas.

The Fiscal Pact includes specific targets and goals in the following areas: tax revenues, increasing social and public spending, maintaining fiscal balance, improvements in the civil service, fiscal transparency, use of public properties, and fiscal decentralization.

Specific targets and goals for taxation are included in the Fiscal Pact. The major specific target was that the tax revenues were to reach 12% of GDP by 2000, which had then been reprogrammed to 2002. The Fiscal Pact also called for a one-off, comprehensive tax reform. The idea of setting these two targets was to address the notion that "the state is poor" and to meet social and peace accord targets, the state would need greater revenues. Coupled with the target of increased taxation and a single, comprehensive reform was the desire to ensure that the tax system would be more progressive, where poorer people pay a lower share of their incomes in taxes than do richer people.

The Fiscal Pact did not create the Superintendency for Tax Administration (SAT), which is discussed below, but it supports the SAT's modernization and strengthening by including a number of specific targets, such as: continuing professionalization of staff, development of a single taxpayer database, and an ethics code.

The Fiscal Pact supports the Peace Accords that call for establishing priorities in public spending to meet commitments to education, health, housing, administration of justice, public security, and rural development. Subsequently, the Government of Guatemala also committed itself to establishing a National Public Investment System and a Multi-Annual Public Investment Program. Additional goals, such as allocating a greater share of public spending to meeting the needs of poorer people, and to reach a target of 4% of GDP for public investment, are included in the Fiscal Pact.

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32 Exceeding 8.0% of GDP seemed like an unreachable target to many outside observers, until the late 1990s.

The Fiscal Pact also has a chapter on transparency and fighting corruption. Within this chapter, there is a goal for improving the availability of fiscal information, stronger public management, and audit of government programs and accounts.

Tax administration

With the signing of the Peace Accords in late 1996, a goal of raising the tax ratio to 12% was set. The revenue was needed in order to finance planned increases in social spending. Thus a more effective approach to tax administration and collection was required. At the beginning of 1997 the Government of Guatemala decided to establish a semi-autonomous revenue administration to collect tax revenues. Throughout the rest of 1997 and during 1998, measures were taken to separate tax administration functions from the traditional line structures within the Ministry of Finance. Using examples from other countries (especially Peru), in 1998 (under Decree 1-98) the Guatemalan legislature established the Superintendencia de Administración Tributaria (SAT). The year 1998 was one of transition, and in 1999 the SAT became fully operational. USAID/Guatemala provided limited but strategic technical assistance that played a key role both during the early formative years of the SAT and into its first several operational years; its influence continues to have significant impact on tax administration and related policy.[33]

USAID assistance at this time was limited but catalytic. USAID financed the establishment of a Project Coordinating Unit within the Ministry of Finance to take the steps to establish the SAT and to negotiate a $28 million loan from the World Bank with the express intent of creating an operational organization. This project provided both national and international consultants in carrying out the following activities:

- Draft of the SAT's Organic Law, which was approved by the Guatemalan Congress on January 12, 1998,
- Preparation of the SAT's 1998 and 1999 budgets,
- Design and approval of the SAT's Internal Regulations and personnel regime,
- Development of an Action Plan detailing steps to be taken for operations,
- Preparation of a four-year budget for the activities to be financed under the forthcoming World Bank loan,
- Designs for the different tax administration modules (e.g., collections, IT systems, auditing, and finance), and
- Training programs.

The World Bank and the Inter-American Development Bank (IDB) worked in close collaboration in providing assistance to the newly created SAT. The IDB, following up earlier assistance programs, provided technical advisory assistance and training in the areas of customs professionalization and modernization, within the SAT. At the same time, World Bank assistance included organizational strengthening of the entire SAT structure and particular assistance in implementing modern systems, especially in the management of domestic taxation. While this report is not an evaluation of the technical assistance projects, there are definite indicators that the SAT had successfully been established and that tax administration after SAT was considerably superior to what it had been before.

In 2001, USAID financed a benchmarking study of the Guatemalan tax system.[34] This study clearly documented the strong improvements in the entire Guatemalan tax system, the positive benefits of which are clearly demonstrated in revenue terms in Figure 8. Unfortunately, shortly after performing the benchmarking study, President Portillo decided to change the management

[33] See USAID (2004c), page 2.

[34] Mann et al, (2001b).

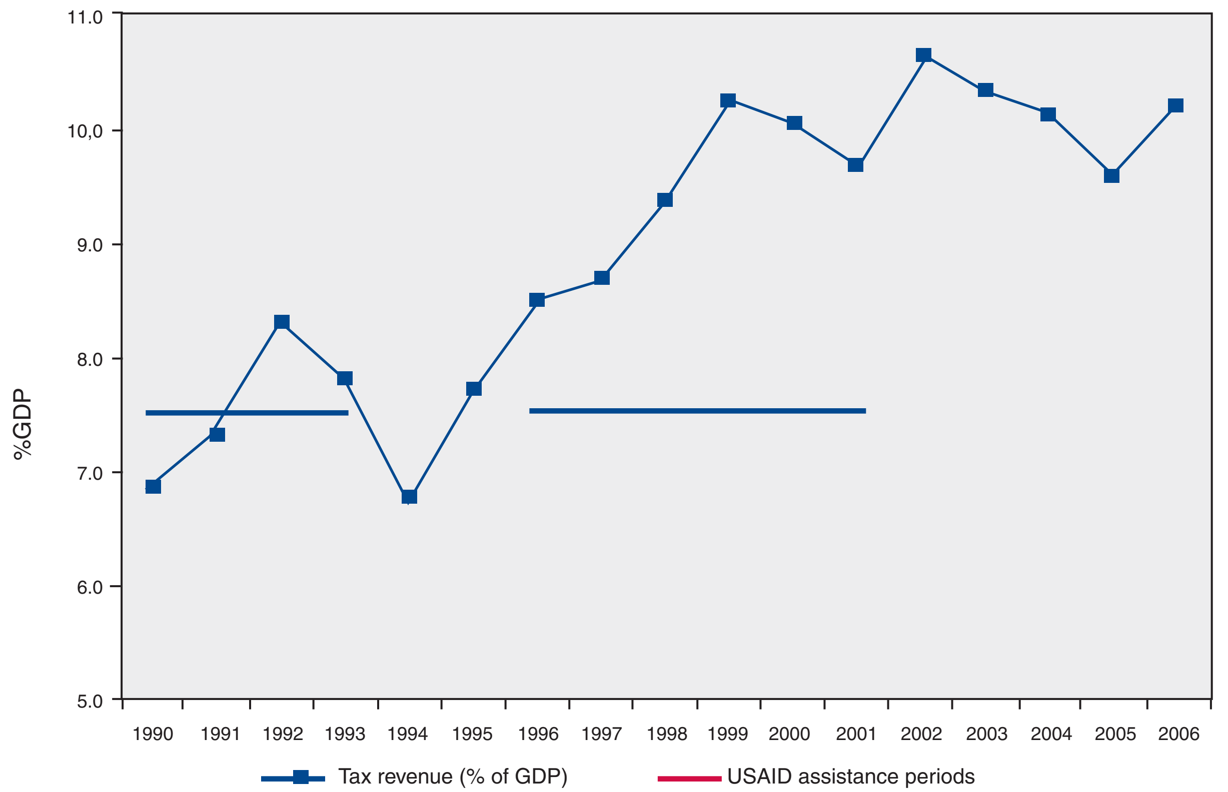
of the SAT and the situation took a precipitous decline, which is delineated clearly in the second benchmarking study, carried out in 2004.[35] Figure 8 also indicates that 2001 had been the peak year. Later data show this decline to have continued until 2006.

It is worth mentioning that shortly after President Portillo's departure from office, his Finance Minister and his final SAT Superintendent were indicted and eventually imprisoned for having diverted about $5 million from SAT collections to fund the political campaigns of URNG candidates. A warrant for Portillo's arrest was also issued, but Portillo, who is also a Mexican citizen, took refuge in Mexico and, as of this writing, had still not been extradited, despite requests by the Guatemalan Government.

Today, in 2007, the SAT seems again to be under good management. Revenue levels (as a percent of GDP) by 2006 still have not achieved the 2001 levels, but this is mainly because certain uneconomic taxes, such as the tax on company assets, have been eliminated, while compliance with other taxes seems to be on the rise.[37]

Figure 8 clearly demonstrates that the tax ratio had been very low in Guatemala. Indeed, the high point of 8.4% of GDP reached in 1992 was

FIGURE 8: TAX RATIO IN GUATEMALA FROM 1990 TO 2006[36]



35 Gallagher et al. (2004).

36 Data are from World Economic Outlook database, April 2007.

37 There is no new benchmarking study demonstrating this. Instead this is based on a presentation by the SAT's newest superintendent, Ms. Carolina Roca, in a recent meeting at the IMF in Washington, DC.

higher than it had been for several years prior and the rise to this level coincides with technical assistance that was being provided to the tax administration by USAID, a project that began in 1989.[38] Project completion seems to have been accompanied by an immediate drop in the tax ratio, although the path to recovery began again after 1995. Further USAID technical assistance was provided in the second half of the 1990s, including training, workshops and more technical assistance. This assistance was instrumental in developing the legislation for the creation of the new semi-autonomous revenue authority, the SAT. Further assistance began in 2001 to carry out a number of studies and technical missions related to the implementation of the Fiscal Pact. Similar assistance was subsequently provided by USAID during the period 2004 to 2006.

In 1998, when the SAT took over all tax and customs administration for the first time, observers expected revenue to decline, but instead it continued to increase. Indeed, by 1999, it already appeared to many that the Fiscal Pact's target of achieving a tax ratio of 12% would be attained. Alas, that goal remains elusive.

Expenditure control and government spending

The Government of Guatemala has made very deep and broad improvements to its public expenditure management system. Much of the technical work in this area has been funded with World Bank loans. Legal, institutional, and personnel changes have been set in motion with the national level government, and implementation is now being extended downward to the municipal government administrations.

The Integrated Financial Administration and Management System (SIAF in Spanish) project introduced important changes including considerable application of information technology in the areas of treasury, public sector accounting, audit, and program budgeting. In 1998, a new "organic" budgetary law was enacted requiring results-oriented budgeting. SIAF and related programs are credited with having introduced considerable improvement in the efficiency of public spending, while also introducing much better data flows and transparent accounting.

The SIAF project also introduced performance and results-based budgeting. Line ministries and agencies set physical and financial targets, which are then consolidated into an overall budget for the Government. Budget execution is reported, also in financial and physical terms, and data are available on the Ministry of Finance website, as well as in printed reports.

One reform that was not a part of SIAF, but marks a milestone in such transparent reporting, is the annual presentation by the SAT of the fiscal revenues foregone in terms of "tax expenditures." In 2001, USAID-funded technical assistance produced the first tax expenditure report for the SAT and taught the techniques of tax expenditure accounting to SAT employees. It was a SAT initiative to continue this reporting on an annual basis.[39] Reporting these tax expenditures has not yet led to further tax reforms, mainly due to reform fatigue, but it does provide plenty of grist for the mill should further tax reforms be contemplated.

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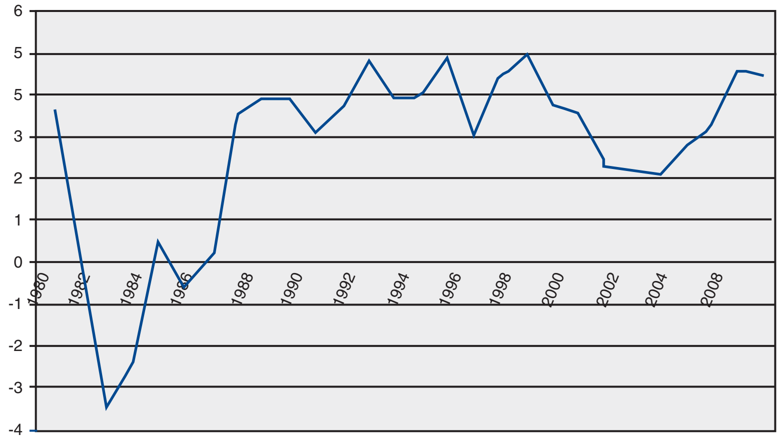
[38] Gallagher (1995) documents the tax ratio trend and USAID assistance to Guatemala's Ministry of Finance and Tax Administration.

[39] See Mann and Burke (2001).

FIGURE 9: ECONOMIC GROWTH RATES IN GUATEMALA[40]



Outlook

Economic growth reached its highest point in 1998, two years after the signing of the Peace Accords and just as the Fiscal Pact was being negotiated. The trend is similar to other economies in the region, but perhaps more pronounced in Guatemala. A particular problem during this period was the populist and highly corrupt Portillo presidency. With the change in regime, the start of greater cooperation among business, government and civil society in general, and a re-igniting of economic reforms beginning in January 2004, the economy has picked up its pace again.

In terms of meeting revenue and expenditure targets set in the Fiscal Pact, despite all the assistance provided by the international community, Guatemala's fiscal system still has not been able to succeed fully. The data in the next chart show that the SAT still has not met the 2000 deadline of achieving 12% of GDP in tax revenue. Government spending referred to as "social and peace accord related" has stagnated in percentage of GDP, and only last year (2006) does it appear to have reached 6.0% of GDP.

Table 8 presents overall fiscal performance from 2001 to 2006. The focus here is not just on the tax ratio, but on other targets or indicators related to overall government budgeting, spending on agreed Fiscal Pact priorities, and the overall fiscal balance.

The Fiscal Pact calls for maintaining an overall fiscal deficit of about 1.0% of GDP. This target clearly has not been achieved. Had the Government met its tax revenue target of 12% of GDP, it could have met its fiscal balance target while attaining the level of spending that it had. Not apparent from the data in Table 8, but from other reporting, it seems that the public investment target has been met, oscillating between 5.5 and 3.4% of GDP during the first five years of this decade.[41]

In terms of meeting the social terms of the Peace Accords as they pertain to the Fiscal Pact, and more importantly, in terms of ameliorating the social and economic conditions, such as poverty, rural underdevelopment, and inequality, Guatemala has made some progress, but it has far to go. As mentioned, the rate of tax collections still has not met the targets that were set in the Fiscal Pact, and subsequently, neither has total govern-

TABLE 8: FISCAL PERFORMANCE IN GUATEMALA SINCE 2001

	2001	2002	2003	2004	2005	2006
	Percent of GDP					
Revenues	11.1	11.4	11.0	10.8	10.3	10.9
Tax	9.7	10.6	10.3	10.1	9.6	10.2
Non-tax	1.4	0.8	0.7	0.7	0.7	0.7
Expenditures	12.9	12.4	13.3	11.8	11.8	12.6
Social and Peace Spending	5.5	5.1	5.3	4.9	5.3	6.0
Other spending	7.4	7.3	8.0	6.9	6.5	6.6
Balance	-1.8	-1.0	-2.3	-1.0	-1.5	-1.7
GDP growth	*2.3*	*2.2*	*2.1*	*2.7*	*3.2*	*4.6*

40 Data are from World Economic Outlook database, April 2007.

41 Data are originally from the Bank of Guatemala, but reported in IMF (2005), page 6.

ment spending. Still, the share of the budget and the share of GDP that is directed to public safety, social spending, and other spending related to the Fiscal Pact, has increased. Indeed, while taxation and overall spending have not increased in real per capita terms, real per-capita social and peace-related spending combined has increased by about 14% since 2001.

There remain wide social and economic gaps among Guatemalans and between Guatemalans and their neighbors. To avoid the next conflict, much more progress is required in terms of increased and improved social and economic spending. Instead of progressing, the country has still not been able to address the yawing gaps among its rural and urban sectors, between it poor and its rich, between its attainments and its potential.[42] Many of the social conditions that were part of the cause of the 36-year conflict continue to fester today. Some important leaders in Guatemala recognize this. Indeed, recently, Nobel laureate Rigoberto Menchu called for a new Fiscal Pact, specifically to reduce inequality in the country.[43]

[42] See Gallagher (2003).

[43] See Inter-American Development Bank (2007).

7 KOSOVO

Mosque in Kosovo

Nature of the conflict

Kosovo has long been the subject of political and territorial disputes between its two main ethnic groups: Albanians and Serbs. The territory took shape in the thirteenth century as a center of political and religious life under the Serbian kingdom, but fell to the Ottoman empire in the fifteenth century, remaining under Ottoman rule for nearly 500 years. During this period, many of Kosovo's ethnic Albanians adopted Islam, while the vast majority of Serbs did not, many leaving Kosovo to flee Ottoman oppression. By the end of Ottoman occupation, roughly 80 percent of the Kosovo population was ethnic Albanian and mostly Muslim.[44]

In the early twentieth century, Kosovo was retaken by the Serbs and continued on as a province of Serbia within what became the Federal People's Republic of Yugoslavia. In an effort to protect Kosovo's Albanian majority and weaken Serbia's position in the Federation, Yugoslavia's leader, Josip Broz Tito, granted the province nominal "autonomous" status and over time delegated it more and more actual powers of self-rule.[45] Despite its special status, Kosovo remained one of least developed areas of the Federation throughout the Yugoslav era.

In the 1970s and 1980s, ethnic strife intensified with the emergence of an Albanian nationalist movement, marked by increasing discrimination against non-Albanians and sporadic outbreaks of violence among Kosovo's various groups. The 1980s saw a backlash of Serbian nationalism in Kosovo. Slobodan Milošević, then a senior ranking official of Serbia's Communist Party, used this discontent to catapult himself into the political limelight during his rise to power in Serbia. By the end of 1989, Milošević had gained effective

44 Much of the information in this section is drawn from http://en.wikipedia.org/wiki/Kosovo. For a more in-depth account of Kosovo's historical development and the lead-up to the 1996-1999 conflict, see Malcolm (1999).

45 Tito, himself and ethnic Croat, ruled Yugoslavia from Belgrade in Serbia, but always sought to keep a lid on ethnic tensions to maintain stability, if not balance.

leadership and control in the federal government, prompting a reversal of fortunes for the Albanian majority of Kosovo, which was swiftly stripped of its autonomy. On July 2, 1990, an unconstitutional Albanian-led parliament declared Kosovo an independent country, although this was not recognized by Belgrade or any foreign states. Two years later, in 1992, the parliament held an unofficial referendum in which 98 percent of voters favored independence, but again failed to receive international recognition.

Emboldened by the 1995 Dayton Agreement (see Chapter 4), a group of ethnic Albanians formed the Kosovo Liberation Army (KLA), employing guerilla tactics against Serb security forces and civilians. Three years of KLA attacks and Serbian reprisals ensued, punctuated by a 1998 ceasefire brokered by US ambassador Richard Holbrooke amid growing western outrage over reports of ethnic cleansing. The ceasefire did not last, however, and heavy violence between KLA and Serb forces resumed. A second round of talks in early 1999 met with sharp resistance from the Milošević regime in Belgrade, which refused to sign the peace agreement as proposed. This stalemate triggered a 78-day NATO campaign between March and June 1999, during which NATO launched air strikes on Yugoslav targets amid continued ethnic clashes and massive outflow of refugees. On June 12 1999, Milošević accepted NATO's conditions, ending the air strikes.

The human toll from the three-year conflict was severe: Roughly 850,000 ethnic Albanians fled or were forcefully driven from Kosovo, and several thousand were killed.[46] The number and the ethnic distribution of the casualties are uncertain and highly disputed. An estimated 10,000-12,000 ethnic Albanians and 3,000 Serbs are believed to have been killed during the conflict. Most of the Serb population that survived left, either during the conflict or in its immediate aftermath; around 120,000-150,000 Serbs, roughly 7 percent of the overall population, remain in Kosovo, but are subject to ongoing harassment, discrimination and violence. Some 3,000 people of various ethnicities are still missing.[47]

After the war ended, the UN Security Council passed Resolution 1244 that placed Kosovo under a transitional administration, the United Nations Mission in Kosovo (UNMIK), headed by a Special Representative of the Secretary General (SRSG).[48] Post-war reconstruction of Kosovo commenced immediately, without awaiting resolution of the sensitive issue of Kosovo's final political status. Eight years later, Kosovo remains nominally a province of Serbia, although Serbia exercises no effective authority over it.

Addressing the post-conflict fiscal challenges

Kosovo was in a different and perhaps more vulnerable position than the rest of the Balkans when the war ended in 1999. As a province of Serbia, it did not have developed (or even nascent) institutions of government.[49] There was no tax policy and no tax administration. There was neither a budget process to form current and capital spending, nor a treasury system to manage the procurement and distribution of goods. Nor was there a pension system or welfare infrastructure to help absorb labor market shocks. In short, unlike its neighbors and other recent war-torn countries, Kosovo had no institutional memory or qualified human capital in the operation of government in general, or in fiscal systems specifically.

Reconstruction in Kosovo, therefore, presented the European Union, the United States and their donor agencies with a unique and daunting task of *creating,* rather than the *reconstructing*, salient government institutions. In fact, of all the post-

[46] See UNHCR (2000).

[47] See http://news.bbc.co.uk/1/hi/world/europe/781310.stm.

[48] UNMIK's exercise of protectorate authority went substantially beyond that exercised by the Office of the High Representative (OHR) in nearby Bosnia and Herzegovina.

[49] Kosovo did have municipal governments and municipal government operations, which were to become increasingly important in the post-conflict era in establishing an institutional base.

conflict economies under recent study only East Timor (not included in this study) begins to approach the *tabula rasa* characteristics of post-conflict Kosovo.

The fiscal challenges facing Kosovo's interim administration were multiple and serious.

The destruction of capital, particularly the housing stock and transport infrastructure, required massive amounts of capital inflow. In the housing sector alone, the EU with the United Nations High Commission for Refugees (UNHCR) set a target to rebuild over 20,000 homes by end of 2001. The spending demands were in large part addressed early at donor conferences in Madrid and later in Brussels, where the EU and US pledged approximately 3 billion DM for reconstruction.[50] This large influx of monies, while seen as a windfall gain to the people of Kosovo, led to a number of problems that the eventual fiscal authority would have to address.

The first problem was fiscal dependency. The large and rapid inflow of capital caused domestic wages to rise rapidly. In many cases, the ethic was simply to rely on donor funding with no concern for its implications: how to maintain these assets, how to address job expectations prompted by the flurry of reconstruction projects, and how to create the management capabilities to run these large capital projects during and after completion.

The second problem was the separation of the capital and current budgets, which has haunted Kosovo to this day. Because of fiduciary concerns about the quality of public expenditure management, donors did not provide cash grant funding for the development budget, but instead financed and managed projects either themselves or via the European Agency for Reconstruction (EAR), their own military operations, or via UN agencies such as UNHCR.[51] At the same time, USAID and the EU set to work on building a Central Fiscal Authority (CFA) to manage current account spending and mobilize domestic and international revenues. The ability of Kosovars to monitor, let alone manage these capital programs developed very slowly in the initial phases of reconstruction.

While the destruction of physical infrastructure in Kosovo was great, perhaps of greater magnitude was the loss of human capital. It was the Serb experts that had managed and run the large publicly-owned utilities and governmental institutions. The en masse exodus of management talent to Serbia and Europe crippled the operation of the economy and left the country without the experience and expertise needed to create the institutions of public governance.

Donors helped build these institutions, develop appropriate policy frameworks, and begin to address the capacity building needs of the nascent Kosovo government.

Under Resolution 1244, the EU was delegated responsibility for the revenue functions of the interim government and the public utilities, but it ran into difficulties very early on in managing these tasks. The EU, therefore, requested assistance from USAID, and in July 1999 USAID launched a technical assistance project with a 20-person team. It was the USAID project that set up the CFA (later renamed the Ministry of Finance and Economy), the Department of Reconstruction (DOR), and the Banking and Payments Authority (later renamed Central Banking Authority of Kosovo), and established the nascent Kosovo Trust Agency to work through all the initial privatization requirements in 1999 and 2000. Lacking indigenous expertise, these institutions were initially staffed and run by donors, especially USAID- and EAR-funded advisors. The USAID team also advised and provided some training to the UN executives on how to manage their line

50 See Department of Reconstruction, Kosovo: *Reconstruction 2000*, April 2000 (report completed by S. Lewarne and USAID in Kosovo April 2000). See pp. 5 and 7 for formal breakdowns of initial demands.

51 This was particularly true of the German Army, which built new roads in the district of Peja.

ministries until Kosovar Albanian counterparts were able to take over these functions after Parliamentary elections in 2004.

Establishment of the CFA (precursor to the Ministry of Finance and Economy)

The Central Fiscal Authority was established by UNMIK decree in October 1999 and USAID and the EU immediately began to staff it with international experts. The areas that demanded immediate attention included: treasury, budget, tax policy, and creation of a macroeconomic policy department to measure and inform long-term economic trends. The CFA's main operations initiated in Kosovo's capital, Prishtina, but it soon managed to bring all 32 municipalities under its direction. By the end of 2000, a de-concentrated fiscal management system was in place and functioning.

The CFA introduced a number of important reforms and developed critical systems for the management of public finances. First, the CFA introduced an integrated financial management information system (IFMIS). This was brought in initially as a simple tracking mechanism (in MS Excel) in order to get an immediate handle on spending and donor funds disbursement. However, within a few months the need for a more sophisticated system became apparent. The new IFMIS was brought online in early 2000 and has been in place ever since.

The CFA drafted a law on public procurement, which the SRSG immediately authorized. This was followed by a series of implementing regulations and development of forms for the use of government funds. The donors then proceeded with training for government staff in the implementation of the new procurement regime.

The CFA dealt immediately with the large spending demands in that it provided legitimacy for continued donor support. At first, all of the departments within the CFA were provided with USAID advisors who had operating authority, but at the same time these advisers provided on-the-job training to Kosovars, many of whom went on to assume these responsibilities within the Ministry of Finance and Economy (MFE), the name by which the CFA is known today.

Pension reform in Kosovo: With USAID assistance, Kosovo introduced a fundamentally new pension system, establishing a critical safety net for the territory's population. The system is composed of three "pillars." The first pillar, funded from general revenues, is a basic old-age pension benefit. The second pillar, a mandatory, defined contribution (PAYE) savings pension scheme, requires all employees to contribute 5 percent of gross salary, matched by a 5 percent employer contribution, to an individual account. Contributions and records are managed by the Kosovo Pension Savings Trust (KPST), an independent body established specifically to administer the savings pension system. The third pillar, entirely voluntary, provides for supplemental individual or employer-sponsored pension schemes.

The pension reform has achieved a number of important policy outcomes. Whereas the prewar pension system covered only half of the elderly population, the new system quickly achieved almost universal coverage—this in an environment where only a small share of the population has formal wage income. Unlike other countries in the region, where pension expenditures eat up increasingly large shares of GDP due to aging populations and political inability to control benefit rates, Kosovo's basic pension benefit was tied to the cost of a monthly food basket to contain costs, so state pension expenditures as a share of GDP should decline over time. Furthermore, contribution rates have been kept low to reduce labor-market distortions. After just four years, the PAYE pillar is fiscally sustainable, with assets around 8% of GDP in 2006, and leaves enough fiscal room for other important needs-based social programs.

Department of Reconstruction and management of the capital budget

The spending demands for infrastructure improvement in the immediate postwar period presented critical problems for the interim government. To address these demands, in early 2000, USAID initiated the Public Reconstruction Investment Project (PRIP). The PRIP project preceded the formation of the Department of Reconstruction and was the first attempt to match line ministry demands with donor financial support—so as to avoid over-spending in the capital program. The PRIP spelled out the demands of each of the 18 budget organizations making up the interim governmental structure for the CFA. The DOR was created to channel the donor funding for capital construction to the CFA, aligning donor pledges with actual demands, and managing the expectations of the donor community.

In the charter establishing the DOR, a sunset clause was established stipulating that by January 1, 2003, the DOR would be dissolved and its functions folded into the Central Fiscal Authority. This was done to avoid the problem of donor "creep" and to enshrine the fundamental need to combine the current and capital budgets under a single fiscal authority.[52]

Tax Policy

Mobilizing domestic revenues presented a particular challenge for Kosovo's interim government. The notion of reporting, let alone paying, taxes was foreign to a large portion of the population. Under the prewar Yugoslav regime, most taxes were taken at source without sophisticated accounting for taxpayer liabilities or payments. The challenge for the government was not just strengthening taxpayer registration and reporting, but also identifying appropriate tax policy in an environment characterized by high unemployment, low incomes, and a large informal sector.[53]

USAID advisors were aware that simplicity of administration would be critical for revenue mobilization in Kosovo. In the immediate stages, therefore, the advisors focused on creating basic, easy to collect taxes with few rate gradations, few exemptions and few credits, levied at low rates. These included hotel and restaurant taxes, sales and excise taxes, and customs duties.

As is often the case in post-conflict economies, where vast imports feed the surge in demand created by a reconstruction program, the best opportunity at revenue collection was initially at the border. Unfortunately for Kosovo, it was not as straightforward as it was in Iraq, Afghanistan, Bosnia or other sovereign states. Unlike Kosovo, these states had (more or less) internationally agreed upon borders. While trade facilitation and tariff setting were important concerns for Kosovo, so, too, was the establishment of a border (or at least a decision on where to place border posts).

The first task was to seek recognition of Kosovo as a trade partner and an "area" that had a border. Macedonia was quick to comply, signing the first border agreement in late 1999.

The more problematic issue was Serbia. Serbia, of course, could not recognize an international border with Kosovo, since by Serbian and international law, Kosovo was a province of Serbia. To circumvent this problem, in September 1999 UNMIK established border posts with the rights of a customs authority several hundred yards inside Kosovo's provincial borderlines with Serbia-Montenegro. The customs duty was set at a flat rate of 10% and imposed on all imported goods, including those from Serbia. As of 2006, customs duties accounted for roughly 15% of all government revenues.

Between 2001 and 2003, tax policy started to become more complex, especially as tax administration capacity improved. In 2001, with USAID support, the interim government implemented a VAT, replacing the sales tax, and in 2002 introduced a simple tax on wages. In 2003, a property tax was introduced, providing an important source of revenue for Kosovo's municipalities.

Since 2003, with continued USAID support, the Kosovar-led government has moved to more

[52] The sunset legislation was insisted on by the USAID contractors and USAID so as to limit the size of government and the number of "revenue" ministries in a small country.

[53] The first serious estimate of the informal sector came only in 2003, where the shadow economy was estimated at 360 million out of a total GDP estimate of €1.219 billion—or 29%. See Stephen Lewarne and Janusz Szyrmer (2003).

complex, broad-based personal and corporate income taxes, strengthened VAT collections (now accounting for 40% of all tax revenues), and introduced a property tax incentive grant to motivate municipalities to improve their collections. Despite the growing sophistication of the Kosovo tax administration and increasing demands for revenue, Kosovo has maintained relatively low and simple taxes.

Tax administration[54]

In developing the tax administration in Kosovo, USAID assistance laid critical foundations for effective tax administration. This assistance was provided in two phases. During Phase I, the Central Tax Administration was established with the basic organizational layout, personnel, systems and procedures necessary for administering the taxes described above. For its IT needs, in 2000 the Tax Administration installed an integrated tax administration IT system to control taxpayer records, returns processing, bank reconciliation and management information.

During Phase II, additional advances were achieved in tax administration. First, responsibility for tax administration was fully transferred to local officials, including the office of Director—a position that had been held by an expatriate advisor—reflecting marked improvements in the capacity and professionalism of local tax officers. In 2005, a new Tax Administration Law based on international "best practice" standards was enacted. The law provides for stricter sanctions against tax evasion; stronger powers for collection; clear protections for taxpayer rights; and, a code of ethics to guide the conduct of tax officials.

The tax IT system has continued to improve in efficiency as users gain experience and as enhanced modules are added. In addition, despite initially poor performance in collecting unpaid taxes, significant strides have been made in the collections area. A vigorous effort has since been underway to rationalize the collections effort and to use the powers of lien and levy when necessary.

Unfortunately, during 2004-05, substantial corruption, fraud, and mismanagement surfaced in the operations of the tax administration. Among others, patronage in hiring, collusion with certain taxpayers, and extortion of others were detected. Under a new minister, these problems were being addressed through a serious internal integrity campaign supported by USAID assistance and a rigorous procedure leading to merit-based hiring decisions.

As Table 9 shows, tax revenues grew remarkably, registering a five-fold increase between 2001 and 2006, with tax and non-tax collections amounting to about 28% of GDP in 2006. In fact, it is a source of considerable pride to Kosovar officials (and the donor community) that since 2001, the tax system has produced sufficient revenues to finance all of the government's current expenditures.

The composition of tax revenues remains a concern. Taxes collected by customs (import duties, VAT, excises, etc.) still account for the vast majority of revenues. More than 80% of VAT revenues and the majority of excises are collected at the

TABLE 9: REVENUE COLLECTIONS IN KOSOVO

	2000	2001	2002	2003	2004	2005	2006
	€ Millions						
* Domestic	2.0	13.6	45.7	98.3	91.1	119.5	154.4
** International	115.1	242.3	364.6	426.8	435.8	435.3	430.0
Total	117.1	255.9	410.3	525.1	526.9	554.8	584.4

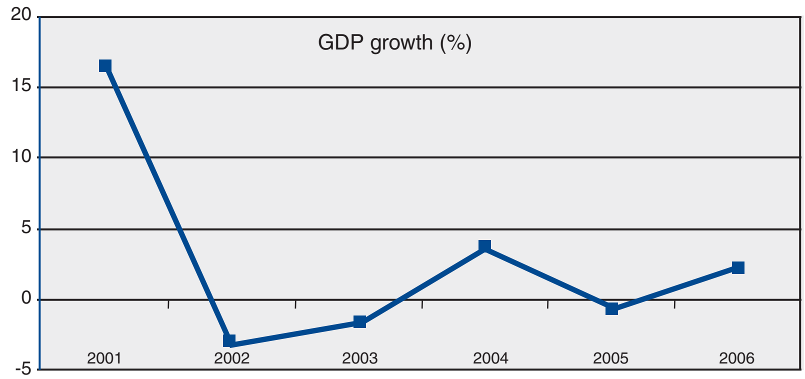
Source: Steve Lewarne's estimates and reconstruction of data from the MFE's Quarterly Macroeconomic Bulletin, September 2006.

Notes: * Total Reported by TAK
** Total Reported by Customs Administration

[54] The section is mainly drawn from USAID (2006b)

border. Nevertheless, the share of domestically collected taxes in total collections has risen from 5 to 27% since 2001, indicating improvements in the composition of taxes and the performance of TAK in encouraging taxpayer compliance.

FIGURE 10: ECONOMIC GROWTH RATES IN KOSOVO[55]



Outlook

Eight years after the conflict, Kosovo's economy is still on shaky ground. Indeed, of all the countries in this study, Kosovo has had the least economic "bounce" after years of intense technical and generous economic assistance. Instead, after some rise in the measured economy in 2000 and 2001, the country has just been tripping along with essentially no growth. As Figure 10 shows, Kosovo experienced double-digit GDP growth in the two years immediately following the war, fueled by remittances from Kosovars living abroad and a massive influx of foreign assistance. After 2001, however, the economy plummeted as domestic sources of growth proved unable to compensate for declining levels of foreign assistance. Indeed, Kosovo's economic circumstances are weak in many areas: 37% of the population lives below the poverty line, with 15% living in extreme poverty. Unemployment is at 40-50%. Fifty percent of the population is under the age of 25. Per capita income is roughly €1,200, the lowest in southeastern Europe, and 2006 exports were less than one-fifteenth of imports, creating a trade deficit of roughly €1 billion—almost 40% of Kosovo's recorded gross domestic product (GDP), and based, in part, on a high dependence on worker remittances.

The economy remains hampered by Kosovo's unresolved international status, which has made it difficult to attract investment and external financing.

[55] Data are based on International Monetary Fund estimates; Ministry of Finance and Economy.

8 LIBERIA

Nature of the conflict

Liberia was established in 1822, with the return from America of freed African slaves. In 1847, Liberia became an independent republic. Ironically, these newcomers, known as Americo-Liberians did not offer full rights to the native, Africa-born Liberian subjects until into the twentieth century, and the constitution still denies citizenship to non-black race or non-African descendants, including the Lebanese community that has been in the country for about a century.

Although far from being a democratic paradise, Liberia had had the longest experience with fairly free elections among all of sub-Saharan Africa. The country had elected governments up until 1980, when Sgt. Samuel K. Doe and a group of other non-commissioned officers of the Republic of Liberia Army (RLA) overthrew President Tolbert, whom they assassinated (along with much of his cabinet of ministers).

During the 1980s, the US Government provided considerable support to the Doe regime, while Doe methodically killed off both his co-coup partners as well as many others in his opposition. In late 1985, a national election was held, which President Doe fraudulently declared to have been in his favor. This electoral result frustrated the population, almost all of whom went to the streets a few short weeks later to welcome the invading force of a former Doe co-conspirator named Kwiwampah. At first Kwiwampah's forces overwhelmed the RLA, but in a few days the RLA managed to turn the battle around and retook all positions that Kwiwampah's men had taken. Kwiwampah and his men were soon slaughtered on the streets of Monrovia.

The country was relatively peaceful until Christmas Eve in 1989, when Charles Taylor, who earlier had been Doe's Head of the Government Services Agency and who had escaped from jail in the US, invaded the country. Taylor's forces first seemed to be liberators, but soon the country sank into increasing conflict among its new warlords, especially Taylor and another new warlord, and former confederate of Taylor's, Prince Johnson. These warlords increasingly were able to finance their efforts from, among other things, the mining and re-export of diamonds, mainly smuggled from Sierra Leone, and especially timber.


Bridge collapse outside Monrovia

President Doe was killed in 1990 by members of a splinter group related to Taylor's National Patriotic Front for Liberia (NPFL). Shortly thereafter, Mr. Amos Sawyer became the new president of a new transitional government.

The Economic Community of West African States (ECOWAS), under mainly Nigerian leadership, with considerable support from the Government of next-door Sierra Leone, sent peacekeepers to Liberia. This peacekeeping force was known as ECOMOG. Taylor perceived the intervention of ECOMOG as directly against his own interests and he also saw Sierra Leone's support of ECOMOG as an attack on him and his group of rebels. Indeed, ECOMOG halted the NPFL's march on Monrovia in 1990. This led to interventions by Taylor's forces and support to the Revolutionary United Front (RUF) in Sierra Leone, resulting in a complete collapse of that country, too.

By the end of 1996, a peace accord was agreed to and, in 1997, elections were held and Charles Taylor won a very decisive majority of the vote.

In 2002, rebels—Liberians United for Reconciliation and Democracy (LURD)—intensified their attacks on Taylor's government. By June 2003, LURD and other rebel groups controlled two-thirds of the country, and together with UN-led sanctions, forced Taylor to abandon the presidency and take refuge in Nigeria. The sanctions included banning all exports coming from the country, and so cutting off Taylor's access to financing. A comprehensive peace agreement was arrived at shortly afterwards, and a transitional government (National Transitional Government of Liberia – NTGL) was set up and led by Mr. Gyude Bryant.

With the negotiated departure of President Charles Taylor in November 2003, Liberia concluded a period of civil war that led to the destabilization of its neighbors and to the collapse of the Liberian state. The transitional period saw intensive international engagement with the reconstruction of the country through the United Nations Mission in Liberia (UNMIL), deployed in September 2003.

The NTGL received considerable assistance from the international community, but this was focused mostly on emergency assistance and poverty alleviation. Historic greed and corruption that intensified under Taylor's kleptocracy became even more pernicious under this caretaker government.[56] There were few efforts at broad institutional reform, although the US Government did provide some technical assistance; US Treasury, for instance, provided advisors in the area of taxation. However, these advisors were frustrated by the indifference and corruption they encountered.[57] Still, the NTGL did usher in the elections of 2005.

In the November 2005 presidential run-off election, Mrs. Ellen Johnson-Sirleaf, a Harvard-educated economist who had worked at the World Bank, defeated George Weah, a former world-class soccer star. In January 2006, she became Africa's first female president. President Johnson-Sirleaf and a cabinet of hopeful technocrats have since been attempting to build a free and democratic Liberia.

In 2006, former president Taylor, in exile in Nigeria, was turned over to an international court in The Hague to face trial on charges of crimes against humanity for supporting RUF troops in Sierra Leone's brutal civil war that claimed the lives of about 300,000 people in the 1990s.

The wars in Liberia were extremely brutal, affecting every community over a fourteen year period and with no clear regional or ethnic divides. About 200,000 people were killed in the war, and half the population was displaced. Nancy Birdsall, during a recent visit to the country, noted in the Center for Global Development's blog, that

> *"…the trauma brought a more complete collapse than the notion of a "war" between two parties suggests. Unlike in the sectarian conflict of the kind suffered in former Yugoslavia and feared in Iraq—where the lines seem clearly drawn across a few ethnic groups—Liberian civilians—all of them but especially women and children—were vulnerable for years to rounds of marauding, looting, pillage and rape."*

[56] Today, Gyude Bryant is being prosecuted in Liberian courts that are also trying to recover the reportedly millions of dollars that he and his underlings siphoned from the public system.

[57] Mismanagement of the country's public finances began long before the years of conflict. Indeed, in the late 1980s, USAID financed the Financial Management Partnership, also called OPEX (for operational experts), in an attempt to force good financial practices upon various institutions of the Liberian public sector. In less than a year, the OPEX advisors left the country, fully frustrated in their efforts to control fiscal revenues and expenditures, due entirely to complete lack of cooperation of Liberian authorities, beginning with President Doe.

Addressing the post-conflict fiscal challenges

With the formal entry into the Presidential Palace of Charles Taylor in 1997, the Liberian economy seemed ready to restart and recover, though from miserable levels. With the renewed onset of war in 2002, the economy again went into a tailspin and by 2004 GDP was about the same in absolute terms as it had been in 1999.

Liberia's needs are immense and are in every sector. Take for instance this assessment of needs for the basic education system.

> *Liberia's education system was virtually destroyed during the recent devastating civil war. Thousands of public primary and secondary schools, as well as technical training schools and the National University, were seriously damaged or looted. The national network of teachers and education managers collapsed as staff across the country were displaced by fighting. Equipment and materials used to manage the sector systematically disappeared.*
>
> Government of Liberia (2007), page 5.

Aside from the urgent need for public spending in all social and economic functions, the country is saddled with the highest international debt burden in the world. According to President Johnson-Sirleaf in a presentation in early 2007 at the Center for Global Development in Washington, DC, external debt came to about $3.7 billion, which is about eight times the entire GDP of the country, and is 300 times the country's current export levels. Indeed, Liberia today is among the most highly indebted countries in the world.

Liberia cannot expect to ever service its enormous debt, and it seems the great bulk of this debt is likely to be forgiven. Aside from the debt problem, in early 2006, there were a number of other fiscal challenges, including:

- Almost negligible tax receipts, coming to about $40 per Liberian per year,[58]
- Extremely weak tax administration,
- State-owned enterprises (SOEs) with extremely weak financial controls, remitting very little to state coffers,
- Little control over public expenditures,
- Corrupt practices throughout the public sector, and especially in procurement,
- No institutional strength in policy analysis and policy making, and
- Vast demands for spending on national reconstruction and reintegration efforts.

Governance and Economic Management Assistance Program (GEMAP)

An EU-funded public sector-wide audit of functions and funds exposed widespread weaknesses in financial controls and corruption. This audit precipitated a number of actions by the international community and the NTGL. In September 2005, the international community and the NTGL signed the GEMAP agreement in direct response to the weaknesses highlighted in the EU-funded audit. GEMAP is a direct response to these systematic weaknesses in the management of public resources, which all partners saw as likely impediments to the successful implementation of post-conflict recovery and reconstruction.

There is considerable goodwill between the newly elected Government and the international community and President Johnson-Sirleaf has continued the GEMAP program, despite its obvious intrusions into the country's sovereignty. The president and her administration recognize the enormous fiscal challenges they face and the need to keep control over the public resources so they can be adequately mobilized and directed toward the country's rebuilding.

During the final year of the Transitional Government, the international community came together to develop the GEMAP program. GEMAP began operations at the start of 2006, with advisors on the ground in the very beginning of the new administration. GEMAP is supported by a wide array of international community organiza-

[58] Tax receipts are not negligible on a tax-to-GDP ratio basis, since GDP is so small, but in terms of the fiscal spending needs of the country.

tions, including USG, African Development Bank (AfDB), World Bank, International Monetary Fund, European Union, United Nations, and ECOWAS. GEMAP provides assistance and some special control features in the following areas, *inter alia*:

- Securing the government's revenue, particularly by imposing greater financial controls over major revenue producers, including: SOEs, the Forestry Development Agency (FDA), customs, and tax administration.[59]
- Strengthening budget and public expenditure management,
- Improving procurement practices, as well as granting concessions (such as for natural resource extraction), and contracting, and
- Reducing corruption, particularly by providing support to the Governance Reform Commission.

Assistance has included technical advisors and financial controllers with signatory powers in the Bureau of the Budget, the FDA, the Port Authority, and the Liberian Petroleum Refining Company (LPRC).[60] The IMF has been supporting the National Bank of Liberia and providing limited, intermittent technical advice to the tax administration and customs, while the World Bank has been supporting the Ministry of Finance. In the meantime, the EU has also been supportive, funding audits of public institutions, and, soon, civil service reform, with plans (late 2007) to provide extended assistance in customs modernization.

GEMAP also provides equipment and capacity building and training. The EU is to begin an important overall public sector reform and capacity building program in early 2007, working jointly with the Civil Service Agency (CSA). Civil service reform is an essential part of the overall program, especially given the extremely low salaries paid to civil servants, the overstaffing of some agencies, the existence of "ghost workers," and very low productivity.

Donor coordination has been extremely positive in Liberia under the Jonson-Sirleaf Government, with the USG taking the lead in supporting the Bureau of the Budget, Liberia Customs Service, three SOEs, and the FDA

Receipts management

A US Treasury advisor expert in IT, funded by USAID, and working closely with the Ministry of Finance and the Central Bank of Liberia, developed a new Bank Payments System (BPS/Flag System) with the intent of eliminating the risks to the fisc described above. Here the "Flag Receipt" refers to the official receipt issued to the taxpayer, indicating that the amount shown had been paid through the banking system to the treasury.

The purpose of the BPS/Flag system was to strengthen and secure the principal source of revenue of the Liberian Government and eliminated potential areas of corruption in the former manual tax payment process by building upon the sound cashier and computer infrastructure of the Central Bank of Liberia. This involved physically placing Central Bank cashier stations in the Ministry of Finance building but still remaining connected to the Central Bank's commercial banking software system.

This system helped eliminate potential fraud and helps the taxpayer, who now can do a one-stop preparation and payment of her taxes in one building. The prior multi-step procedure required the taxpayer to:

1. Go first the Ministry of Finance to declare and prepare her tax bill, then
2. Go to her commercial bank and purchase a manager's check, then
3. Go to the Central Bank and pay the tax bill, then
4. Return to the Ministry of Finance to show proof of tax payment, then finally

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[59] As of this writing, there has actually been only very limited assistance, either technical or material, provided to customs and tax administration.

[60] LPRC does not actually refine petroleum, but is responsible for the storage of petroleum at the seaport of Monrovia.

A leaky receipts system. Before the BPS, government receipts had been handled entirely in a paper-based system. Taxpayers delivered their documents and payments to the Ministry of Finance and the Central Bank of Liberia, and were then issued receipts. These receipts could be issued for amounts that did not actually reflect the amount of payment. For instance, a taxpayer might pay $10 in customs duties, but be issued a receipt for $50, and thereby be able to cancel his import duty obligation, withdraw his goods from customs, and save $40 or share this savings with the clerk issuing the falsified payment receipts. The risk to the treasury is obvious, but the actual losses had not been quantified.

5. Take physical receipt to Bushrod Island (this is where the seaport is located, a five-minute to one-hour trip from downtown Monrovia) to obtain the release of Cargo.

The system replaced the hand-written BPS and Flag receipts that were being falsified in Liberia. By computerizing the BPS in the Ministry of Finance and giving the Central Bank cashier function direct access to the Ministry of Finance's database to produce a printed Flag receipt, all manual hand written documents were eliminated and a centralized database was established for control both by Ministry of Finance and the Central Bank. The system was fully operational January 30, 2006 under the new administration. The new system has also eliminated the need for a physical receipt since the data are now accessible on-line via a microwave link set up with this USAID funded assistance.

So far, the new BPS/Flag system seems stable, free of error and available on a continuous basis. No work stoppages or days have been lost to either equipment malfunction or software error. Indications are the new BPS/Flag system has helped to increased revenues substantially, but the amount of the increase that can be attributed to the new system has not yet been estimated.

Revenue enhancement

One source of lost revenues under the Taylor regime and the NTGL had been corruption and tax evasion relating to logging and export of Government-owned tropical timber. These abuses had led to a UN embargo on imports of Liberian logs in 2005. Nonetheless, the NTGL continued to grant logging concessions. Within two weeks of taking office, President Johnson-Sirleaf cancelled all forestry concessions. A new forestry law was enacted to curb illegal logging and to help Liberia responsibly manage its timber resources. These actions subsequently led to the lifting of UN timber sanctions, paving the way for Liberia to resume log exports. To curb tax evasion in this sector, the Government, with USAID assistance, has been developing a framework and system for securing custody over all felled or sawn timber.

The new Government is steadfastly battling corruption, putting in place sound financial management procedures for public enterprises. Domestic revenues during the second half of 2006 nearly doubled compared with the same period the previous year. Since 2005, moreover, the Government has taken a number of additional steps to enhance revenues. For instance, importers had been free to allow their goods to be subject to pre-shipment inspection (PSI) prior to departure from the exporting country, or pay a fine of 3.5% of CIF value. Many chose to pay the fine rather than submit to PSI. This fine has now been doubled to 7% and more goods are being subjected to PSI than before. The fine may go up to 20% in 2007. Meanwhile, the Government is trying to better manage import exemptions, including misapplication by numerous NGOs, and has also widened the tax base of the Goods and Services Tax. The selective and excise tax rates have been increased on restaurants, beer, and tobacco products and the excise tax was harmonized between domestically produced and imported products.

The Government hopes to increase the share of its revenues coming from direct taxes, especially company income taxes. Given the human resource constraint in the tax administration and the lack of broader economic and juridical institutions, this strategy may warrant reconsideration.

It is worth noting that the early tremendous success in improving revenues, both from customs and from internal or domestic revenues, has been based mainly on efforts made by the Liberians themselves. Donor technical assistance has been minimal. As of the mid-2007, the EU had provided a single, resident technical advisor to customs, whereas all assistance to the tax administration since the beginning of the Johnson-Sirleaf Government had been only short-term visits by IMF advisors. Little to no capacity building assistance or material support, such as computers and data systems, has been provided.

Budget

Leaders of the reform-minded government elected in 2005 recognize the urgent need to improve its control of public spending. Because of bloated ranks of public employees, as well as the existence of "ghost employees" inherited from prior governments, a very large share of budget expenditures goes to paying salaries, while little was available to pay for supplies, maintenance, and operations.

Improving the strategic aspects of the Liberian budget process is one of the concerns for improving the budget system expressed in the IMF Staff Monitored Program (SMP). The Liberian Government and the IMF discussed establishing a Medium Term Expenditure Framework (MTEF) as a longer-term goal. At the same time, the basic system of national accounts remains inadequate and according to the IMF probably understates overall GDP. Complete and comprehensive MTEFs always build upon appropriate macroeconomic frameworks, which should be based on both acceptable quality macroeconomic data as well as strong analytic capability.

Meanwhile, commitment control and control over cash balances have been seen as more urgent requirements than long-term planning.

In relation to control over cash balances of the Government, the IMF had proposed to the Johnson-Sirleaf Government that it establish a cash-based budget. The Ministry of Finance established the Cash Management Committee to take the lead in this area. The World Bank has been supporting the implementation of the cash-based budget since 2004. World Bank support has included providing technical assistance, including one international advisor and one national advisor, as well as broader support to the Ministry of Finance.

The World Bank coordinates its support to the Ministry of Finance through the Resource Management Unit, which was established for the purposes of managing the technical assistance already mentioned, as well as provides training to Ministry of Finance officials in public financial management. The head of the Resource Management Unit, an international advisor, also has signatory authority over all Ministry of Finance disbursements.

USAID has provided support to the Bureau of the Budget, which was recently merged into the Ministry of Finance, as a component of GEMAP, providing an international advisor who has signatory powers over the authorization of all allotments to line ministries and other budgetary entities. This advisor's role was crucial in addressing a key problem where the Bureau of the Budget had issued allotments that far exceeded both appropriation levels, as defined in the annual budget law enacted by the Legislature, and available funds. This created frustration and a perversion of the budgeting system. As of this writing, the USAID-funded GEMAP advisor, through her signatory authority, continues to ensure that no allotments are made that exceed appropriations.

Overall fiscal performance

The results, in terms of the measures to improve the public finance system for increased revenues and expenditures, have been impressive. Table 10 shows that total tax revenues for the 2007/2008 fiscal year (beginning July 1), based on data available as of March 2007, were projected to far exceed those of the prior fiscal year. Indeed, total tax revenues are expected to rise by 44% over 2006/07. Two-thirds of the increase comes from taxes on international trade, but income taxes have also risen quite rapidly. Much of the income tax revenue increase seems to derive from withholding tax on public sector employees and growing public sector payrolls.

Total government expenditure is expected to double in the 2007/2008 fiscal year, compared to 2006/2007. Some of this will pay for increased spending on salaries arising from needed salary improvements, but it also includes increased spending on other goods and services and capital expenditure.

The Government of Liberia is owner of a number of SOEs or similar agencies, which it is hoping will be able to generate significant revenues to fund future government operations. This strategy warrants some review. For instance, the LPRC holds a state-sanctioned monopoly on the storage of gasoline and diesel in the national seaport, and all imports by private sector firms must pass through this storage facility and pay LPRC rather high storage costs. LPRC uses this revenue to fund its operations, possibly make new investments, and pay a dividend to its owner, the Liberian Government.

The Liberian Government also operates the Forestry Development Agency (FDA) and has been hoping that once the timber industry revives, which it will in short order, that revenues may rise to about $15 million per year, or more. These revenues essentially come from taxing the felling of timber, what is know as a "stumpage fee."

The FDA has been planning to not remit these funds to the treasury, however, but rather to use these funds to pay for community development and conservation activities, outside the usual budgeting processes.

The National Port Authority (NPA), which is supposed to regulate the country's ports, also holds a monopoly on port services throughout the country. The NPA operates the ports and generates profits, which it may share with the Government, spend according to its own budget priorities, or reinvest in port operations. An alternative model for NPA operations is to not act as a company at all, and to not provide port services, but rather to serve as one of a few port development agencies that would help to coordinate and oversee the operations of private sector shipping services firms that compete for port services. The NPA could foster development in the port area and in the surrounding areas. It could ensure that planning and development of the various private sector providers are coordinated, and it could ensure that standards are met for security, service, and quality of infrastructure. Indeed, the NPA might consider leasing or concessioning most of the port operations that it now undertakes itself.

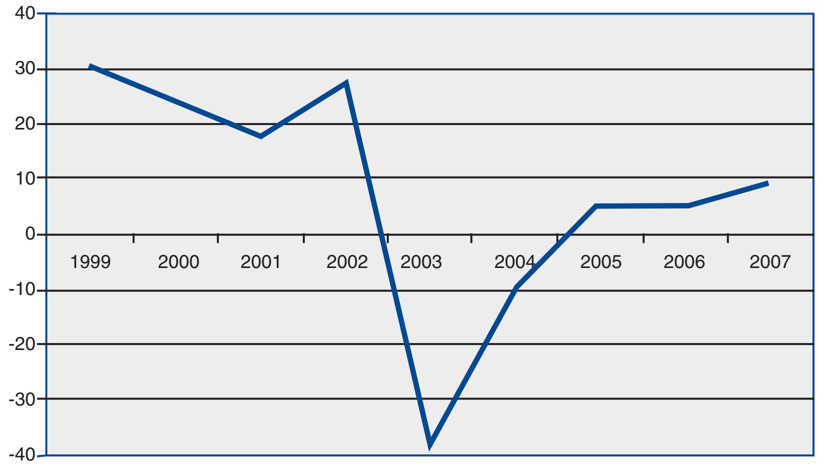
TABLE 10: FISCAL PERFORMANCE IN LIBERIA SINCE 2002/03

	2002/03	2003/04	2004/05	2005/06	2006/07e*
	US $ millions				
Total Revenues and Grants	56.6	59.0	80.3	89.6	135.1
Total Revenues	56.6	56.0	79.3	84.6	120.9
Tax Revenues	48.5	55.3	75.7	81.0	116.8
Customs	23.9	24.3	30.2	35.3	56.4
Income taxes	9.4	9.4	28.4	25.1	33.7
Non-tax	8.1	0.8	3.6	3.6	4.8
Stumpage fees	7.3	0.1	0	0	0
Transfers from SOEs	0	0	0	0	0.8
Total Expenditures (cash)	69.2	50.6	77	72.2	152.5
Wages	13.1	24.3	42.3	30.7	48.5
Overall balance (cash basis)	-12.6	8.4	3.3	17.4	-17.4

Note: Fiscal Year begins July 1.
Data from IMF SMP (April 2007)
*"e" is expected outturn.

Outlook

FIGURE 11: ECONOMIC GROWTH RATES IN LIBERIA[62]



Two years after the first post-conflict elections, there is considerable optimism about the future of Liberia, but it is important to keep in mind just how poor the starting conditions have been. Per capita income is about $150, compared to 1985 when it was about $450, not adjusted for inflation. Government revenues amounted to about $120 million in 2006, but were five times this amount in the mid-1980s, during the dark years of the Doe regime. Despite recent advances, half the children are still not able to attend school. One tenth of the population has died in the violence and a quarter of the people were made refugees or internally displaced.[61] People do not have clean water, electricity, or most other basis services, and about 80% of the urban population is without steady employment. There is optimism, but the road ahead is still long and difficult.

Figure 11 clearly shows a stabilizing return to economic growth, but there are two problems. First, given the large inflows of foreign assistance and accompanying local spending, the sustainability of this growth path is still in question. Second, given the earlier destruction of infrastructure and decline of economic activity, there seems to be little "bounce" in the Liberian recovery; indeed, real GDP per capita at the end of 2006 was still nearly 30% below that in 2002. El Salvador experienced similar rates of economic growth after cessation of the conflict, but had suffered far less destruction. BiH, which had suffered in many senses as intensively as Liberia, though for a far shorter period, experienced post-conflict economic growth several times that in Liberia.

Two important revenue measures the Government of Liberia has been planning for 2007 are to expand the Bank Payment System that handles, controls and reports on government receipts, developed with US Government assistance; and to extend pre-shipment inspection of imports to cover secondary ports. Related measures include more strictly enforcing customs regulations with respect to religious organizations and NGOs, and redoubling efforts to collect outstanding tax arrears. In addition, the Government is planning a number of tax policy changes that it hopes will increase revenues without unduly causing economic harm, including: raising excise taxes on alcohol and cigarettes; and, broadening the tax base for the Goods and Services Tax.

[61] Many refugees have returned to Liberia, and many IDPs have returned to their home cities, towns or villages.

[62] Data are from World Economic Outlook database, April 2007

9 SOME GUIDELINES FOR THE FUTURE

This chapter draws upon the experiences and critical review of the efforts at building or strengthening fiscal systems in the post-conflict countries of Afghanistan, Angola, Bosnia and Herzegovina, El Salvador, Guatemala, Kosovo, and Liberia. The first part of this chapter provides some guidance on how to provide assistance, while the second section attempts to set a strategy for sequencing of assistance interventions.

Some pointers

1. **Diversity.** There are many commonalities among post-conflict countries, but the richness of experiences derives from the diversity of experiences. Knowledge of specific country situations is more important than the rest of the general guidelines that follow.
2. **The nature of the conflict and the nature of the peace.** It is important to understand the causes for the conflict, the roles of conflicting parties, the role of the international community in the conflict, as well as the nature of the post-conflict situation. In Bosnia and Herzegovina, the nature of the peace accord, which is the country's constitution, creates extreme public finance complications. In Angola, it is difficult to accept technical or other assistance from foreign donors, since some of those same donor countries were actively supporting rebel factions during the country's civil war.
3. **Rebuilding countries always face severe fiscal challenges.** The nature and severity of the challenge varies from case to case, but fiscal challenges always loom in post-conflict countries, including, for example: lack of skilled cadres, destroyed tax bases, weak organizations and institutions, and massive public spending needs. Expertise among donor teams in developing and implementing thoroughgoing fiscal modernization programs is almost always an urgent need for post-conflict rebuilding programs.
4. **Lack of counterparts.** Post-conflict countries usually have had their professional ranks devastated. Donors need to be aware that they will likely play a much more involved role in these countries than they would in most developing or transitional countries. Not only is implementation capacity weak or nearly non-existent; in some cases, there may also be few people responsible for making the decisions about these very important issues.
5. **Beware of cronyism and corruption at the top.** The excellent work done by many Guatemalans of the various parts of society in developing the Fiscal Pact and in creating the Superintendency for Tax Administration was all put in peril by corruption starting at the top under the Portillo presidency. In Liberia, the international community had hoped after the toppling of the Taylor regime that the National Transitional Government of Liberia under Gyude Bryant would usher in a new period of peace and recovery. Under UN military control, peace was achieved, but Bryant and his cronies looted the various institutions under their control. Building fiscal regimes and institutions is not recommended unless they can be protected from such kleptocratic behavior.
6. **Politics is always at issue.** The ethnic basis for politics in Bosnia and Herzegovina has impeded rational policymaking since the end of the war and required considerable intervention by the International Community. In Guatemala, creating the fiscal pact was an act of brilliant consensus building and political coalition building that has been driving fiscal reform, albeit with fits and starts, for the past decade. The lack of competitive politics in Angola keeps that country obscured by poor statistical information, while buoyant oil revenues help to reduce incentives to make needed radical reforms. A strong mandate to the new government and a seeming drive for integrity at the highest level in Liberia has

given a legitimacy and mandate for reform never before seen in the country.

7. **Build trust.** In most cases, there is little trust among people and between ethnic groups. Perhaps the Fiscal Pact in Guatemala provides the best example of how diverse socio-ethnic and ideological groups and individuals can come together in a very polarized society to hammer out a workable consensus that sets both a framework for peaceful reform as well as a system for monitoring its implementation. Trust building was also part of the reforms in the other countries studied here, but Guatemala's is the only case where this was a fundamental aspect of reform and progress.

8. **Include civil society.** Once the very basic controls over the budget are established, efforts must be made to bring civil society into the policy dialogue process. Civil society led reform programs in El Salvador and Guatemala. Civil society is being consulted in Liberia to rally support for reforms, especially against government corruption. Civil society only recently has joined discussions about fiscal system development in Bosnia and Herzegovina, and has played no role in such discussions in Angola.

9. **Get control over the receipts process.** Tax administrations and budgeting systems can be strengthened, but if the taxes that are paid by taxpayers do not actually go into government coffers, the efforts are for naught. Fixing the receipt system in El Salvador had immediate impact on government realized revenues and the fiscal deficit. The new automated receipts system in Liberia directly contributed to rapid increases in revenues. The issue was more complicated and quite pressing in the case of Bosnia and Herzegovina, where a new computerized receipts management system was required to replace the antiquated and institutionally unsound systems managed by the country's three ethnically-based payment bureaus, which themselves were being eliminated. This can be a quick, relatively cheap fix, that can have significant impact on the fiscal system.

10. **Get control over the expenditure process.** Demands will be placed immediately on the ability of the government to distribute funds to meet the demands of implementing peace accords and initiating reconstruction. In many cases, the government will be responsible for setting up special agencies that can quickly and efficiently direct funds to the appropriate places, such as the Social Investment Fund in El Salvador or similar but donor-operated funds, such as those in Kosovo and Afghanistan.

11. **Customs before domestic tax administration.** Taking a strong hand in customs management has been key to gaining the urgently needed tax revenues in all the case countries studied, except Angola.

12. **Short-run versus long-run solutions.** It may be necessary to make decisions that in the short-run help to address the fiscal situation, but over the longer term may be detrimental to sustained growth and development. One example of this is the reliance on rent-generating state-owned enterprises in Liberia to generate revenues for the cash-starved government, but which is a poor means of economic organization for longer-run growth and economic freedom. A second example is the reliance on customs duties, such as in Bosnia and Herzegovina, for revenue generation, at the longer run cost of reduced competitiveness and economic efficiency and welfare.

13. **Do not neglect tax policy.** Tax policy options and choices must be studied at the very onset of recovery. Tax policies from the former Yugoslavia, had they been fully enforced in Bosnia and Herzegovina, would have completely devastated private initiative. Tax policy reforms in El Salvador helped that country on the road to economic consolidation and growth, thereby making the reconciliation and reconstruction processes more tenable.

14. **Informality and illicit activities.** Tax administration, customs, and revenue policies must take into account the likelihood of considerable economic activity taking place

outside of the formal sector, whether this be smuggling of consumer goods across borders in the Balkans or the illicit production of poppies and heroin in Afghanistan. Tax and import duty policies and administration should encourage formalization of business, using simplified forms, simple information requirements, reasonable tax rates, and streamlined processes. Addressing illicit activities goes beyond tax policy, but good tax laws with solid tax and customs administrations and related law enforcement apparatus can help to reduce the costs to society of these activities.

15. **Phase in tax policies.** Phase in tax policies in a way that is consistent with the ability of the authorities and the economy to manage them. For instance, the focus on indirect taxes, whether strengthening border taxes or introducing a VAT, is probably a better approach than would be to move directly to modern personal and corporate income taxes. One reason for this is that indirect taxes are often easier to collect, such as at border crossings or in warehouses. Since some indirect taxes are not obvious to the taxpayer, there is likely to be less resistance to paying the tax. Finally, many tax administrations simply do not have the administrative infrastructure or trained staff capable of auditing corporate income and loss statements and balance sheets, that would be needed for a modern corporate income tax.

16. **Build analytic ability and policy-making processes.** Although it may be necessary to design policies without local input, it would be better to develop some analytic capabilities at the same time, such as in El Salvador, belatedly in BiH, and ongoing in Angola. Creating a macroeconomic unit or policy analysis unit in the Ministry of Finance or in the Office of the President is important to ensure that future policymaking does not rely solely on the advice of foreigners. It is also important in generating broader support for policy reform, which is necessary for sustaining the reforms in the intermediate to longer terms.

17. **Building analytic skills is more difficult than building administrative skills.** Despite the value of building analytic capacity, it must be recognized that this includes a complete set of tools of analysis and education in new ways of thinking. This will take much longer and will be much more challenging in many ways than would be, for instance, training tax administration staff to implement newly computerized processes.

18. **Take a holistic approach to fiscal reform.** Donor cooperation and coordination is important. However, it is not enough for donors or other government agencies to meet periodically to discuss the aspects of the work they are covering: someone with an overall vision, with a strategic understanding of fiscal issues, from policy to implementation, must lead the process.

19. **IT solutions can play an important role.** Automation of expenditure, treasury, and tax administration processes can help to ease the administrative burdens on these systems, reduce corruption and evasion, and make up for shortages of human capital. IT solutions should not drive reform; they should facilitate it. IT solutions in BiH were key to ramping up tax revenues and for gaining greater control over the expenditure systems, but they followed process simplification and were accompanied by training, organizational change, and overall management strengthening.

20. **Look closely at statistical systems.** It will be extremely difficult to build a stable economy without adequate macroeconomic and fiscal data. Reforming an economy, building a government and a private sector, without national accounts, is like driving a car at night without headlights. Assistance should be provided in these areas.

21. **Building fiscal institutions is a long-term proposition.** Reconstruction has focused on the rebuilding or rehabilitation of destroyed economic infrastructure, such as roads in Afghanistan, bridges in El Salvador,

and housing in BiH. Paving roads and restoring blasted out public buildings would seem rather straightforward and implementation can be planned using normal project management tools. Building fiscal institutions includes public policy making, politics, social change, organizational change, human and institutional capacity building, and a great deal of public discussion and education. This endeavor has taken many years in each case before yielding results.

Sequencing activities

While sequencing assistance activities and reform focus is important, there is no science to it. Keeping in mind the above pointers, it is clear that each country's experience will be unique and how exactly we approach that country's requirements will be quite specific to that country. However, just as above, there are some lessons that we can draw from the experiences documented in this report with regard to sequencing.

In general, the most immediately pressing matters deserve the most immediate attention. That said, there are many matters that are immediately pressing. Immediate focus is usually given to fixing the expenditure management system, mainly because donors are planning to funnel large financial assistance into a country, in part through government coffers. Yet in some cases, donors have found that the public management system was too broken, too corrupt to bother with, such as was the case during the National Transitional Government of Liberia (2003-2005), when donors directly provided many basic public services.

Another area for immediate or early focus has been the revenue system. This was true in Kosovo and Liberia, for instance. In Kosovo, donors began with a *tabula rasa* and so had the advantage of first defining the region's tax system, focusing on indirect taxes and taxation of some luxury items. In Liberia, the IMF had focused on strengthening the tax administration based on already existing tax policies that had been established decades before. Technical assistance on tax policy should be accompanied by a clear understanding of tax policies and these should be appropriate for the circumstances. For instance, technical assistance for the audit of corporate income taxes in Liberia, where tax inspectors in 2007 were earning salaries of only about $55 per month, might not be the most effective means of support.

In BiH, the International Community had provided considerable assistance in strengthening the tax administrations before anyone noticed that full implementation of the tax laws would kill off all legitimate business in the country. Fortunately, the still weak tax administrations had not been able to focus on much more than collecting indirect taxes for several years.

The point is, policy, whether tax or expenditure policy, is important and it is important from the beginning. This does not mean that building policy-making capacity is an immediate concern, but understanding the policy and legal and regulatory framework for the fiscal system must be tackled from the beginning.

Reforming tax policy in countries where we do not have a tabula rasa typically takes considerable time. It will take time to develop the policy analytic skills that are required. It will take time to collect the data and carry out the analyses. It will take time to develop proposals, market the reforms, and draft new legislation, and then ensure its implementation. Misguided legislators may resist reform. Still, when strengthening the tax administration, donor support should focus on collecting the most reasonable taxes, while ignoring the uneconomical, business-unfriendly taxes. If feasible, attention should also focus on reducing privileges while simplifying taxes, thereby easing compliance and tax administration burdens, while preserving revenues and improving the business environment.

When taking steps to build the public expenditure management system, donor support must first focus on the treasury system. How receipts come into the fisc, how they are accounted for, and how these public monies are then disbursed and the controls over these, is elemental.

In a post-conflict situation, public expenditure is needed everywhere. Still, there is a need to give some reasoned thought to how public resources should be allocated, determine the greatest needs and payoffs, and undertake planning for multi-year activities. Nothing important can be done in one year, so we should not plan to spend only over one year. Once the most important, the direst needs, are being addressed, assistance will be needed to help develop public spending targets, develop investment projects, and allocate resources to where they will have the highest socio-economic benefit. Skills, procedures, and organizational structures are needed to modernize the budgeting system. A new budget system law is also often needed to set the rules and organizational set up of the budgeting system.

Tax policy without data is sterile and academic, although it can be common sense-based for the immediate post-conflict period. The same is true for annual budgeting. However, governments must plan their activities with an eye not only toward current needs, but also toward future development. Governments must also be accountable to their people and to the international community, who have been providing them with considerable assistance. This means that statistical systems need strengthening.

Table 11, below, recommends that intense and urgent attention be focused immediately on strengthening the basics of expenditure control and, on the revenue side, collection of indirect taxes. Immediate attention should also be given to the analysis of overall fiscal policies, including macroeconomic policies, taxation, and government spending, but perhaps at a lower level of intensity. The reason for this reduced level of intensity is that host-country counterparts will most likely not be able to absorb all the assistance donors can provide and they will also feel the most urgent needs in getting money into the treasury and getting it out to meet priority demands.

Building expenditure and revenue systems will assist in building the basic building blocks of the rebuilding country's statistical system, but donors will likely also need to provide assistance in improving the national accounts, including household and industrial surveys, census, and improved methods. However, while this work is important and fiscal planning cannot be done without reasonable data, host country governments are unlikely to consider this a top priority.

Donor assistance can be helpful in building fiscal policy analytic skills and policy-making capacity.

TABLE 11: SEQUENCING ACTIVITIES

Item	Urgent	Immediate	Intermediate	Consolidating
Expenditure control				
Receipts management				
Indirect tax control				
Direct tax control				
Fiscal policies capacity				
Economic and fiscal statistics				
Reform of tax policy				

	High-level of effort and assistance intensity
	Lower level of assistance intensity
	No assistance during phase

This includes multi-year and annual budget planning, revenue forecasting, public investment planning and management, macroeconomic stabilization policies and growth forecasting and resource needs identification. Fiscal policy-making capacity requires technical knowledge, statistical systems, organization, and political and technical leadership. While this may be the least urgent of all aspects of rebuilding the fiscal infrastructure, it is likely to take the greatest amount of time. Nonetheless, it is the most important from a strategic perspective since it sets the basis for thinking and planning for future economic and social recovery.

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