

**THE INTERNATIONAL FINANCIAL INSTITUTIONS:  
Postconflict Reconstruction and Peacebuilding Capacities**

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*Paper prepared for the Center on International Cooperation, New York University,  
on behalf of the Royal Ministry of Foreign Affairs, Government of Denmark*

Seminar on ‘Strengthening the UN’s Capacity on Civilian Crisis Management,’  
UN Secretary General’s High-Level Panel on Threats, Challenges and Change

Copenhagen

8-9 June 2004

## EXECUTIVE SUMMARY

This paper assesses the capacity of the international financial institutions – the World Bank, International Monetary Fund, and regional development banks – to respond effectively in the planning and implementation of the civilian components of postconflict reconstruction and peacebuilding.

It begins with an overview of the current roles of the international financial institutions (IFIs) in postconflict reconstruction and peacebuilding operations. Particular attention is given to developments at the World Bank, which has moved further than other IFIs in addressing the distinctive challenges posed by engagement in postconflict reconstruction and peacebuilding. The roles of the IMF and the regional development banks also are briefly described.

The paper then identifies critical areas where capacity building at the IFIs could enhance the effectiveness of their contributions to reconstruction and peacebuilding. Key recommendations are:

- The IFIs should invest in development of capacity to assess the impacts of their policies and projects on horizontal equity – that is, on disparities across lines of ethnicity, region, religion, and race – and should incorporate horizontal equity impact assessment into policy formulation and project appraisal.
- To reconcile macroeconomic stabilization and political stabilization – goals that should be mutually supportive – capacity should be built to monitor indicators of both (including alternative macroeconomic indicators, such as the purchasing power of the population) and to assess potential tradeoffs between them.
- The IFIs should develop tools for evaluation of operational units and staff performance in terms of the quality and quantity of outcomes as opposed to the quantity of lending.
- The IFIs should develop the capacity to balance efficiency gains from trade liberalization against costs of lower tariff revenues and the consequent reduced funds available for peacebuilding expenditures.
- The IFIs should develop capacities to evaluate the potential fiscal contribution of luxury taxes and to assist in their design and implementation.
- The IFIs should explore ways to tap incomes generated in postconflict aid bonanzas to prime the pump of domestic revenue collection, among other ways by negotiating payments in lieu of taxes for their own personnel and contractors.

- To improve their capacity to implement peace conditionality – for example, by incorporating peace-accord commitments into Interim PRSPs – the IFIs should explore how their aid can be more closely articulated with steps to implement the accords and consolidate the peace.
- Building on precedents in international law, including the current discussions of Iraqi debt, the IFIs should establish a body to assess the possible scope and implications of initiatives to erase ‘odious debts’ inherited by postconflict governments.

## **THE INTERNATIONAL FINANCIAL INSTITUTIONS: Postconflict Reconstruction and Peacebuilding Capacities**

### **1. INTRODUCTION**

This paper assesses the capacity of the international financial institutions – the World Bank, International Monetary Fund, and regional development banks – to respond effectively in the planning and implementation of the civilian components of postconflict reconstruction and peacebuilding. It is written as a contribution to the Center on International Cooperation’s report on the capacity of the United Nations system to address these challenges, commissioned by the Government of Denmark.

The paper begins with an overview of the current roles of the international financial institutions (IFIs) in postconflict reconstruction and peacebuilding operations. Two sets of critical issues are then discussed, with a view to formulating actionable proposals for improving IFI capacities to contribute to these tasks. The first set of issues pertains to the reorientation of conventional IFI policies in light of the special requirements of postconflict transitions – the need to do some things differently. The second set of issues involves distinctive tasks that arise in postconflict environments – the need to do some different things.

### **2. OVERVIEW OF THE ROLE OF THE IFIs IN PEACEBUILDING**

This section provides a brief overview of the current roles of the World Bank, International Monetary Fund (IMF), and regional development banks in postconflict reconstruction and peacebuilding operations.

#### The World Bank

In its early years, in the immediate aftermath of the Second World War, postconflict reconstruction was the World Bank’s principal occupation; hence the ‘R’ in the IBRD – the International Bank for Reconstruction and Development – the Bank full name. In subsequent years, however, the Bank moved away from postconflict reconstruction, concentrating instead on development assistance. In the mid-1990s this began to change, as demand grew for postconflict assistance and as the Bank became more willing to venture into terrains where ‘political considerations,’ designated as off-limits in the Bank’s charter, are interwoven inextricably with economic considerations.

In 1997, the World Bank’s board of directors approved a framework paper on engagement in countries emerging from intra-state conflict. The paper defined ‘reconstruction’ to encompass more than rebuilding infrastructure, speaking of the need to support ‘the reconstruction of the *enabling conditions* for a functioning peacetime

society’ [emphasis in the original]. The framework paper also took a broad view of the ‘postconflict’ time frame, delineating five stages for World Bank engagement beginning with a ‘watching brief’ in war-torn countries with no active Bank program. It stated that even once ‘normal operations’ are resumed, the Bank’s country assistance strategy ‘should spell out what is needed to ensure that future operations not only do not exacerbate existing tensions but also contribute in a positive way to growth with equity.’<sup>1</sup>

In 1998, the Bank’s Operations Evaluation Department produced a five-volume report on *The World Bank’s Experience with Post-conflict Reconstruction*, comprised of detailed analyses of Bank operations in El Salvador, Bosnia, and Uganda, and shorter reviews of experiences in Cambodia, Eritrea, Haiti, Lebanon, Rwanda, and Sri Lanka. This study doing some things differently; for example, it concluded that ‘immediate and widespread privatization may well not enhance the prospects for sustained, equitable development, and may even make them worse.’<sup>2</sup> The report also advocated doing some different things; for example, it concluded that ‘if tax effort and the pattern of public expenditures have a direct bearing on post-conflict reconstruction, as they did in El Salvador, it is legitimate to include these parameters in the conditionality agenda’ – a break with the view that these were ‘political’ matters beyond the Bank’s purview.<sup>3</sup>

In January 2001, the Bank issued formal directives on Operational Policies and Bank Procedures (OP/BP 2.30) regarding development cooperation and conflict. These focus in particular on the preparation of a Transitional Support Strategy (TSS) as an initial step in developing a program of Bank assistance in the aftermath of conflict, the second of the five stages identified in the 1997 framework paper. Although reiterating the prohibitions in the Bank’s Articles of Agreement from ‘interfering in the domestic affairs of a member or from questioning the political character of a member,’ OP 2.30 states: ‘The TSS is closely aligned with the objectives and sequencing of priorities of peace accords and rehabilitation plans agreed to by parties to the conflict.’<sup>4</sup> Support for implementation of peace accords thus is interpreted as being consistent with the Bank’s mandate – potentially allowing for closer coordination between the economic and political dimensions of peacebuilding. In an effort to strengthen Bank capacities, BP 2.30 states that ‘an advisory committee of Bank experts, with experience in previous conflicts and

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<sup>1</sup> World Bank, *Post-Conflict Reconstruction: The Role of the World Bank*, 1998, pp. 5 and 9.

<sup>2</sup> Alcira Kreimer *et al.*, *The World Bank’s Experience with Post-conflict Reconstruction* (summary volume). Washington, DC: World Bank, 1998, p. 34.

<sup>3</sup> *The World Bank’s Experience with Post-conflict Reconstruction. Volume III: El Salvador Case Study*, 4 May 1998, p. 51.

<sup>4</sup> World Bank Operational Manual, Operational Policy 2.30, January 2001, para. 3.b and 10. Available at <http://wbln0018.worldbank.org/Institutional/Manuals/OpManual.nsf/0/5870698DE018C520852569E5004EC9AD?OpenDocument>.

other emergencies' will be established by country teams to assist in the preparation of TSSs.<sup>5</sup>

Several important institutional innovations have been undertaken at the World Bank to build capacity for engagement in postconflict reconstruction and peacebuilding:

(i) The *Conflict Prevention and Reconstruction Unit (CPRU)*, originally called the Post-Conflict Unit, was established in 1997 (the name change, in September 2001, reflected willingness to engage with a broader range of conflict-related issues). The CPRU's work includes assistance in the design of TSSs, and training and capacity building within the Bank. However, the CPRU's institutional location within the Bank's Social Development Department limits its role in operational policy making.

(ii) *Trust fund administration*: In the past decade the Bank has begun to administer trust funds that channel grants (as opposed to loans) for emergency projects and budget support in postconflict environments. The first such arrangement was the Holst Fund for the West Bank and Gaza, created in 1994, which broke new ground not only by involving the Bank in trust fund administration but also by doing so in an entity that is not a member of the World Bank. The impetus for this novel arrangement did not originate in the Bank; on the contrary, the Bank agreed to perform this role only after the US Treasury Secretary interceded personally with the World Bank's president. Once this precedent was established, however, trust fund administration became an accepted function of the Bank; subsequent examples include funds for Bosnia, Kosovo, Timor-Leste, and Africa's Greater Great Lakes Region (the latter being earmarked for demobilization and reintegration expenditures). Trust fund monies are contributed by bilateral donors, and in some cases they tap the Bank's own net income.<sup>6</sup> The Bank also established a Post-Conflict Fund for small grants, and the IDA-12 and IDA-13 agreements included provisions for grants to postconflict countries prior to the clearance of arrears on debt to the Bank.

(iii) *Demobilization and reintegration programs*: Beginning with a project in Uganda in 1994, the Bank has funded 27 projects in 16 countries intended to assist in the reinsertion of former combatants into productive civilian life. These projects have become an important component of the Bank's portfolio in postconflict countries. A recent Bank report comments, however, that 'there has

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<sup>5</sup> World Bank Operational Manual, Bank Procedures, BP 2.30, January 2001, para. 7. Available at <http://wbln0018.worldbank.org/Institutional/Manuals/OpManual.nsf/0/47D093717D013139852569E5005124F2?OpenDocument>.

<sup>6</sup> For details, see Salvatore Schiavo-Campo, 'Financing and Aid Management Arrangements in Post-Conflict Situations,' World Bank: Conflict Prevention & Reconstruction Working Paper No. 6, June 2003. Available at [http://lnweb18.worldbank.org/ESSD/sdvext.nsf/67ByDocName/FinancingandAidManagementArrangementsinPost-ConflictSituations/\\$FILE/WP6June18.pdf](http://lnweb18.worldbank.org/ESSD/sdvext.nsf/67ByDocName/FinancingandAidManagementArrangementsinPost-ConflictSituations/$FILE/WP6June18.pdf).

been no comprehensive evaluation of lessons learned and development of best practice guidelines.’<sup>7</sup>

(iv) *Conflict sensitivity assessment*: The need for ‘social assessments’ that ‘focus on patterns of distribution of resources within a society and emphasize inclusiveness of opportunities’ was noted in the Bank’s 1997 framework paper.<sup>8</sup> OP 2.30 further calls for ‘integrating a sensitivity to conflict in Bank assistance.’<sup>9</sup> Yet progress in this direction has been slow. For macro-level analysis the CPRU has developed a ‘Conflict Analysis Framework,’ but there is a long way to go before this is mainstreamed, as the CPRU observes: ‘While there is an increasing awareness both in the Bank and among partners about the potential folly of ignoring conflict in strategy work, many country development strategies still remain largely “conflict blind”.’<sup>10</sup> At the micro (i.e., project appraisal) level, the CPRU currently is developing a ‘Peace and Conflict Impact Assessment tool’ to focus on ‘the specific intervention and its likely impact on peace and conflict.’<sup>11</sup> This component of conflict sensitivity assessment has yet to be designed, let alone to become standard practice. Apart from specialized assessment tools – and possibly more important in terms of operational impact – there is scope to integrate conflict sensitivity into other activities such as the Poverty Reduction Strategy Paper (PRSP) process and Poverty and Social Impact Assessment (PSIA). This has yet to be done. For example, the CPRU remarks that ‘there is no consensus, let alone best practices, on how to integrate the conflict nexus’ into PRSPs for conflict-affected countries.<sup>12</sup>

(v) *The Low-Income Countries Under Stress (LICUS) initiative*: The events of September 11, 2001, prompted the World Bank to reconsider the policy it adopted in the late 1990s of concentrating resources on countries with ‘good policies’ in

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<sup>7</sup> *The Role of the World Bank in Conflict and Development: An Evolving Agenda*. World Bank: Conflict Prevention and Reconstruction Unit, 2003, p. 32. For discussion, see Nat J. Colletta *et al.*, ‘Disarmament, Demobilization, and Reintegration,’ in Robert I. Rotberg, ed., *When States Fail: Causes and Consequences* (Princeton: Princeton University Press, 2004).

<sup>8</sup> *Post-Conflict Reconstruction: The Role of the World Bank*, p. 19.

<sup>9</sup> World Bank Operational Manual, Operational Policy 2.30, January 2001, para. 5.

<sup>10</sup> ‘The Conflict Analysis Framework,’ World Bank Conflict Prevention and Reconstruction Unit, Social Development Department Dissemination Notes No. 5, October 2002. Available at [http://lnweb18.worldbank.org/ESSD/sdvext.nsf/67ByDocName/TheConflictAnalysisFrameworkCAFIdeifyingConflict-relatedObstaclestoDevelopment/\\$FILE/CPR+5+final+legal.pdf](http://lnweb18.worldbank.org/ESSD/sdvext.nsf/67ByDocName/TheConflictAnalysisFrameworkCAFIdeifyingConflict-relatedObstaclestoDevelopment/$FILE/CPR+5+final+legal.pdf).

<sup>11</sup> *The Role of the World Bank in Conflict and Development: An Evolving Agenda*, p. 13.

<sup>12</sup> *Ibid.*, p. 14. For discussion of PRSPs, see IMF and International Development Association, ‘Review of the Poverty Reduction Strategy Paper (PRSP) Approach: Early Experience with Interim PRSPs and Full PRSPs,’ 26 March 2002. Available at <http://www.worldbank.org/poverty/strategies/review/earlyexp.pdf>.

the name of ‘aid effectiveness.’<sup>13</sup> After 9/11, a World Bank report recalls, ‘Staff in the Bank wondered aloud, “should we have been absent from Afghanistan for so long, was there anything we could have done differently?”’<sup>14</sup> The result was the Low-Income Countries Under Stress (LICUS) initiative, managed by a newly created unit that is located in the Bank’s Operations Policy and Country Services Vice-Presidency (in contrast to the more marginalized position of the CPRU). The aim of the LICUS initiative is to undertake ‘difficult partnerships’ in countries where national capacities are ‘participation and transparency-constrained.’<sup>15</sup> The Bank notes that ‘all LICUS are conflict-prone, although not all conflict-affected countries are LICUS.’<sup>16</sup> How, and how well, this initiative will address governance issues in these countries remains to be seen. It seems likely, however, that national capacity building will require complementary capacity building within the Bank itself.

### The International Monetary Fund

To address the challenges of postconflict reconstruction and peacebuilding, the International Monetary Fund (IMF) has modified some of its normal policies and practices, but on the whole the IMF has not introduced institutional changes comparable to those at the World Bank. At the level of formal policies, the main innovation has been the expansion of the Fund’s ‘emergency assistance’ window to cover specifically postconflict assistance. In addition, Fund staff members have played key roles in re-establishing monetary, financial, and fiscal systems in places where they must be built more or less from the ground up, as in Bosnia, East Timor, Kosovo, and Afghanistan.

(i) *Emergency assistance*: In 1962, the IMF instituted a policy whereby it could provide quick-disbursing emergency assistance loans in the wake of natural disasters, without conditionality and without the usual phasing of disbursements. In 1995, the Fund expanded this policy to postconflict situations. The first use of this new window was a \$45 million loan to Bosnia in December 1995, the same month the Dayton Peace Agreement was signed. By 2002, nine countries had received a total of roughly \$340 million in IMF postconflict emergency assistance.<sup>17</sup> In practice, there is somewhat less to this assistance than meets the eye: much of the money (including the Bosnia loan and the biggest single drawing, a \$151 million loan to Yugoslavia after the Kosovo war) has been used

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<sup>13</sup> This approach to aid allocation is known as ‘selectivity.’ For discussion, see *Assessing Aid: What Works, What Doesn’t, and Why*. Washington, DC: World Bank, 1998.

<sup>14</sup> *The Role of the World Bank in Conflict and Development*, p. 6.

<sup>15</sup> World Bank, ‘Structuring Aid to Sustain Governance Reform in Low-Income Countries Under Stress,’ September 21, 2003, pp. 1-2. Available at <http://www1.worldbank.org/operations/licus/>.

<sup>16</sup> *The Role of the World Bank in Conflict and Development*, p. 15.

<sup>17</sup> For details, see <http://www.imf.org/external/np/exr/facts/conflict.htm>.

to repay bridge loans from bilateral donors, which in turn were used to clear arrears to the IMF. In effect, then, ‘emergency assistance’ has been a vehicle for rescheduling arrears to the IMF.<sup>18</sup> This clears a hurdle to renewed IMF engagement, but otherwise it does little to directly address postconflict needs.

(ii) *Technical assistance*: More substantive IMF engagement comes via the technical assistance provided by IMF staff in the establishment (or re-establishment) of monetary, financial, and fiscal systems. Since 2003, the Financial Infrastructure Division within the IMF’s Monetary and Financial Systems Department has been given special responsibilities to tackle postconflict tasks in the monetary and financial areas. In the three other departments of the Fund – the Fiscal, Legal, and Statistics Departments – a small number of Fund staff play a similar role, with the same individuals often moving from one postconflict country to the next.<sup>19</sup>

### The regional development banks

The Inter-American Development Bank (IDB), the Asian Development Bank (ADB), and the European Bank for Reconstruction and Development (EBRD) are involved in postconflict reconstruction operations. The IDB, for example, has been the single largest source of external assistance in postconflict El Salvador and Guatemala, and chairs the donors’ Consultative Groups for both countries. Similarly, the ADB has been an important source of postconflict assistance in Cambodia and Afghanistan, and the EBRD is engaged in the countries of the former Yugoslavia and the former Soviet republics. The role of the African Development Bank (AfDB) has been more limited, due to its recent restructuring and modest resources.

Notwithstanding these involvements, the regional development banks have yet to develop strategic policies and operational capacities specifically oriented to postconflict reconstruction and peacebuilding. The IDB’s operational policy on ‘natural and unexpected disasters,’ for example, contains no explicit reference to violent conflict; ‘human-generated actions’ are mentioned as a possible cause of disasters, but the policy focuses on natural disasters and, to a lesser extent, technological accidents such as oil spills and chemical releases. The IDB policy requires ‘natural hazard risk assessment,’ alongside environmental impact assessment, for all IDB-financed projects; conflict

<sup>18</sup> On bridge loans for arrears clearance, see IMF and World Bank, ‘Assistance to Post-Conflict Countries and the HIPC Framework,’ April 20, 2001, p. 24. Available at <http://www.imf.org/external/np/hipc/2001/pc/042001.htm>.

<sup>19</sup> See, for example, Åke Lonnberg, ‘Building a Financial System in Afghanistan,’ paper prepared for the Bonn symposium on State Reconstruction and International Engagement in Afghanistan, June 2003, available at <http://www.afghanistan-rg.de.vu/arp>. See also Åke Lonnberg, ‘Restoring and Transforming Payments and Banking Systems in Post-Conflict Economies,’ IMF Monetary and Exchange Affairs Department, May 2002; available at <http://www.imf.org/external/np/leg/sem/2002/cdmf/eng/lonnb.pdf>. For an example of the results of IMF technical assistance, see UNTAET Regulation No. 2000/1 on the Establishment of the Central Fiscal Authority of East Timor, January 2000, available at <http://www.un.org/peace/etimor/untaetR/Reg001E.pdf>.

impact assessment is conspicuously missing.<sup>20</sup> The IDB recently initiated a review of this policy, convening a seminar on ‘Human Disasters: Conflict, Terrorism, and Technology’ in June 2003.

Similarly, the ADB’s *Disaster Management* handbook focuses exclusively on ‘natural calamities ranging from earthquakes to volcanic eruptions and from cyclones to floods.’<sup>21</sup> Spurred by its engagement in Afghanistan, the ADB announced in June 2003 that it is drafting a comprehensive emergency policy for conflict-affected countries.<sup>22</sup>

In sum, the regional development banks today are roughly where the World Bank was around eight years ago: they have begun to appreciate that the issues posed by conflict and postconflict peacebuilding warrant explicit consideration, but they have yet to devise and institutionalize policies for addressing these issues, let alone build the new capacities that would be needed to implement these policies.

### 3. DOING THINGS DIFFERENTLY

To respond effectively to the challenges of postconflict reconstruction and peacebuilding, the IFIs cannot stick to the same policies they would follow if a country has never had a civil war. In postconflict settings, a recent World Bank document acknowledges, ‘the main objective over the short to medium term must be to consolidate peace.’<sup>23</sup> There are important complementarities between peacebuilding and the more conventional goals of efficiency, economic growth, and poverty reduction. But these goals are perfectly congruent, and it cannot be assumed that peacebuilding can be secured simply as a by-product of business as usual.

Two sorts of innovations are needed. The first involves modifications of existing policies and practices to take into account the special circumstances of postconflict environments. This requires the willingness and capacity to *do some things differently*. The second involves efforts to address issues that may be absent or avoidable in ‘normal’ contexts but that must be faced squarely in postconflict settings. This requires the willingness and capacity to *do some different things*.

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<sup>20</sup> Inter-American Development Bank, ‘Operational Policy-704: Natural and Unexpected Disasters,’ March 1999. Available at <http://www.iadb.org/cont/poli/OP-704E.htm>.

<sup>21</sup> W. Nick Carter, *Disaster Management: A Disaster Manager’s Handbook*. Manila: Asian Development Bank, 1991. For description, see <http://www.adb.org/Publications/product.asp?sku=0008P>.

<sup>22</sup> ‘ADB Provides Proactive Assistance to Conflict-Affected Countries, Drafts Emergency Policy,’ Asian Development Bank, News Release 086/03, 24 June 2003. Available at <http://www.adb.org/Documents/News/2003/nr2003086.asp>.

<sup>23</sup> *The Role of the World Bank in Conflict and Development*, p. 14.

This section considers innovations of the first type – departures from business as usual – focusing on measures needed to improve the capacity of the IFIs to do things differently. Three key issues are singled out for attention: (i) horizontal equity impact assessment; (ii) rethinking macroeconomic stabilization; and (iii) reforming incentive structures within the IFIs.

### 1. Horizontal equity impact assessment

As noted above, the World Bank has acknowledged the need for ‘integrating a sensitivity to conflict in Bank assistance,’ and the Bank’s CPRU has developed a conflict analysis framework for this purpose. Perhaps the IMF and the regional development banks will follow this lead. Conflict analysis cannot simply be tacked onto standard operating procedures and added to the job descriptions of current staff members, however. To carry out such analyses, and to reframe assistance strategies and redesign projects in light of the results, will require a deliberate and sustained process of capacity building.

A critical area for such capacity building is in assessment of the ‘horizontal equity’ impacts of policies and projects. ‘Horizontal equity’ refers to disparities across social groups, defined in terms of ethnicity, region, religion, and race, whereas ‘vertical equity’ is defined in terms of differences between rich and poor regardless of group identities. Horizontal disparities are often viewed as playing a central role in inciting or perpetuating violent conflict.<sup>24</sup> In this connection it is important to distinguish between *levels* of inequality and *changes or trends* in inequality over time. The latter can spark greater antipathy than the former. In Rwanda, for example, widening economic inequalities in the late 1980s and early 1990s have been cited as one factor in escalation of ethnic tensions that preceded the 1994 genocide.<sup>25</sup>

In ‘postconflict’ transitions, the risk of renewed outbreaks of violent conflict remains high: World Bank studies report that there is a 44% chance of resumption of conflict in the first five years after a civil war.<sup>26</sup> Although horizontal equity impact assessment is especially important in these settings, the IFIs (and the donor community more generally) lack adequate capacity for this task. ‘Donors have not been very good at understanding the underlying political economy of many of the countries with whom we deal,’ the chair

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<sup>24</sup> See Kofi Annan, ‘Peace and Development - One Struggle, Two Fronts,’ address to World Bank staff, 19 October 1999; available at <http://www.reliefweb.int/w/rwb.nsf/0/4eea64265493fc048525680f006deaf5?OpenDocument>.

For discussion, see also Frances Stewart, ‘Crisis Prevention: Tacking Horizontal Inequalities,’ *Oxford Development Studies* 28(3), 2000.

<sup>25</sup> See Peter Uvin, *Aiding Violence: The Development Enterprise in Rwanda*. West Hartford: Kumarian, 1998. See also Nat J. Colletta, ‘Human Security, Poverty and Conflict: Reform of the International Financial Institutions,’ in L. Chen, S. Fukada-Parr, and E. Seidensticker, eds., *Human Insecurity in a Global World*. Cambridge: Harvard University Press, 2004.

<sup>26</sup> Paul Collier *et al.*, *Breaking the Conflict Trap: Civil War and Development Policy*. Washington, DC: World Bank, 2003, p. 83.

of the OECD's Development Assistance Committee recently remarked. 'We underinvest badly in history.'<sup>27</sup> In addition to history, capacity building will require investments in political science, anthropology, and sociology, and the application of economic analysis to this important but unexamined dimension of income and wealth distribution.

**Recommendation:** *The IFIs should invest in development of capacity to assess the impacts of policies and projects on horizontal equity, and should incorporate horizontal equity impact assessment into policy formulation and project appraisal.*

## 2. Rethinking macroeconomic stabilization

'Macroeconomic stabilization' refers to the goal of stabilizing prices and the exchange rate by means of fiscal and monetary policies. In the division of labor amongst the IFIs, this is mainly the province of the IMF. During postconflict transitions, stabilization is not only a matter of macroeconomics: political stabilization is at least as crucial. While there is a broad complementarity between the goals of macroeconomic and political stabilization, there can be important tradeoffs, too. The IFIs – particularly the IMF – need to develop greater capacity to evaluate these tradeoffs so as to incorporate them into policy design.

More specifically, the relationship between budget deficits and social tensions requires careful analysis. The IMF generally assumes that the inflation associated with larger budget deficits would fuel social tensions; whereas critics of Fund programs generally assume that budget-deficit reduction measures exacerbate tensions. Both arguments are plausible: there may be a U-shaped relation between budget deficits and social tensions, wherein deficits that are too high or too low both lead to greater social tensions. If so, the IFIs need to explore (i) how to identify the turning point on this curve; and (ii) how the curve can be shifted so as to relax trade-offs between macroeconomic stability and social tensions.<sup>28</sup>

This issue surfaces in recent World Bank research that finds that 'social policy is relatively more important and macroeconomic policy is relatively less important in postconflict situations than in normal situations.' Apart from the direct benefits of social expenditure, the Bank suggests that 'by prioritizing social inclusion, the government may indirectly reassure investors' and thereby encourage private-sector investment. 'If opportunities exist for modest trade-offs that improve social policies at the expense of a small deterioration in macroeconomic balances,' the Bank concludes, 'growth is, on average, significantly augmented.'<sup>29</sup> The same logic can be applied to public investments in new democratic institutions.

<sup>27</sup> Remarks by Richard Manning reported in World Bank, 'Structuring Aid to Sustain Governance Reform in Low-Income Countries Under Stress,' September 21, 2003, p. 11.

<sup>28</sup> For discussion, see James K. Boyce and Manuel Pastor, 'Macroeconomic Policy and Peace Building in El Salvador,' in Krishna Kumar, ed., *Rebuilding Societies After Civil War*. Boulder: Lynne Rienner, 1997.

<sup>29</sup> Collier *et al.*, *Breaking the Conflict Trap: Civil War and Development Policy*. Washington, DC: World Bank, 2003, p. 155.

In addition to assessing such trade-offs, rethinking macroeconomic stabilization during postconflict reconstruction and peacebuilding could extend to reconsideration of the indicators by which macroeconomic performance is measured. Rather than targeting *inflation*, as is the standard practice today, policymakers could target the *purchasing power* of the population. The main argument for controlling inflation during postconflict transitions is it would erode the real incomes of the poor. If so, why not target purchasing power directly? This would require investments in capacity to monitor not only the prices of basic necessities but also wages and other incomes.

**Recommendation:** *To reconcile macroeconomic stabilization and political stabilization – goals that should be mutually supportive – capacity should be built to monitor indicators of both (including alternative macroeconomic indicators, such as the purchasing power of the population) and to assess potential tradeoffs between them.*

### 3. Reforming incentive structures within the IFIs

In recent years there has been much discussion of the need to move to ‘outcome-oriented’ measures of performance at the IFIs. Operational units and staff members often are evaluated on the basis of their ability to ‘move the money’ – that is, the quantity of loans committed or disbursed – rather than on the basis of the results of their lending decisions. Remarking on this problem, a 1998 World Bank study noted that many task managers regard the volume of loan commitments as an end in itself, and appear to be willing to permit ‘substantial’ sacrifices in quality in return for modest increases in the quantity of lending.<sup>30</sup>

This incentive structure militates against time-intensive efforts to improve aid effectiveness, including any prospective efforts to integrate conflict sensitivity analysis into project appraisal. It also penalizes decisions *not* to lend, despite the potential importance of such decisions for the implementation of peace conditionality, an issue discussed in the next section.

Changing the ‘approval-and-disbursement culture’ at the IFIs would require development of alternative measures of performance. To this end, the IFIs need to build capacity not only to assess progress in terms of peacebuilding as well as economic variables, but also to assess the effects (both positive and negative) of IFI policies and projects on these outcomes. To some extent, such capacity already exists, as for example in the Operations Evaluation Department at the World Bank, whose 1998 evaluation of postconflict reconstruction is cited above. But to incorporate such assessments into evaluation of the performance of country teams and staff members – so as to alter the incentive structures they face, and hence the decisions they make – will require strengthening existing capacities.

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<sup>30</sup> World Bank, *Assessing Aid: What Works, What Doesn't, and Why* (Oxford: Oxford University Press, 1998), p. 142.

**Recommendation:** *The IFIs should develop tools for evaluation of operational units and staff performance in terms of the quality and quantity of outcomes as opposed to the quantity of lending.*

#### 4. DOING DIFFERENT THINGS

This section considers the second type of innovations required to orient IFI policies and practices more effectively to the challenges of postconflict reconstruction and peacebuilding: the need to tackle problems that typically do not arise or can be avoided in ‘normal’ contexts. Once again, three key issues are highlighted: (i) domestic revenue mobilization; (ii) peace conditionality; and (iii) the legacy of odious debts.

##### 1. Mobilizing domestic revenue

Often one of the most pressing issues in postconflict countries is the need to raise government revenues so as to finance the implementation of peace accords, the functioning of new democratic institutions, and social expenditures. The IFIs often assist in design of taxation policies and development of government capacity for revenue collection, yet there is considerable room for more to be done.

In postconflict settings, efforts to mobilize domestic revenue cannot focus solely on the *quantity* of government revenue, although this is critical. Attention must be paid at the same time to the *distributional incidence* of the tax system. There is scope for collaboration here between the IFIs and the United Nations Development Programme, which is currently seeking to set up a global taskforce on ‘pro-poor domestic resource mobilization.’<sup>31</sup> Again, the incidence of fiscal policies across regional, ethnic, linguistic, racial, and religious divides (‘horizontal equity’) may be just as important as their progressivity (or regressivity) defined in more usual (‘vertical’) terms. This requires building greater capacity for monitoring and analysis both at the IFIs and in national agencies.

Three policy options for revenue mobilization that deserve serious consideration are highlighted here: tariff policy; luxury taxes; and innovative strategies to tax incomes generated by aid flows.

##### (i) Tariff policy

In some cases, the imperative of domestic revenue mobilization runs up against other IFI priorities. Tariff policy is a case in point. In general, the IFIs regard trade taxes as ‘distortionary’ interferences with the logic of comparative advantage, and they press for lower of tariffs in the name of efficiency. A side effect of this policy prescription is losses

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<sup>31</sup> Terry McKinley, ‘Overview of UNDP’s Support to Poverty Reduction Strategies,’ New York: UNDP, 2004.

of tariff revenues, which often are the single most important source of government revenues in low-income countries.<sup>32</sup>

In postconflict countries, the need to safeguard and enhance government revenues is especially acute. Yet even in these countries, zeal for trade liberalization often overrides fiscal concerns. In Guatemala, for example, where the peace accords include explicit targets for increases in the ratio of revenues to national income, the IMF urged the government to ‘resist pressures to increase import duties or delay the scheduled reduction in customs tariffs,’ warning that ‘these actions will have adverse effects on output growth.’<sup>33</sup>

**Recommendation:** *The IFIs should develop the capacity to balance efficiency gains from trade liberalization against costs of lower tariff revenues and the consequent reduced funds available for peacebuilding expenditures.*

(ii) Luxury taxes

Domestic revenue mobilization in postconflict settings often faces two serious constraints: weak administrative capacities for tax collection, and the need to ensure that tax policies are perceived as legitimate by the public. The Guatemalan peace accords, for example, specify not only that revenues should be increased but also that they should be collected in a manner that is ‘fair, equitable and, on the whole, progressive.’ Luxury taxes – including tariff surcharges on luxury imports – can combine administrative feasibility and distributional progressivity. Yet today luxury taxes are largely absent from IFI policy prescriptions. Here, too, capacity building at the IFIs is needed in order to develop their ability to evaluate the revenue potential and distributional impacts of luxury taxes. A good starting point for such capacity building would be a comprehensive assessment of past experiences with luxury taxation in diverse settings; remarkably, even this has yet to be done.

**Recommendation:** *The IFIs should develop capacities to evaluate the potential fiscal contribution of luxury taxes and to assist in their design and implementation.*

(iii) Taxing postconflict aid bonanzas

After the signing of a peace accord, countries often experience an ‘aid bonanza,’ thanks to large-scale external assistance from the IFIs, UN agencies, bilateral aid donors, and non-governmental organizations. In some cases – East Timor and Afghanistan are extreme examples – aid flows generate the most substantial and visible incomes in the entire economy. Yet for the most part these incomes are exempt from taxation by domestic authorities. The failure to tax aid bonanzas has three adverse consequences.

<sup>32</sup> Barsha Khattry and J. Mohan Rao, ‘Fiscal Faux Pas? An Analysis of the Revenue Implications of Trade Liberalization,’ *World Development* 30(8), 2002.

<sup>33</sup> Statement by the IMF Staff Representative at the Consultative Group Meeting on Guatemala, Brussels, 22-23 October 1998. For discussion of this and other cases, see James K. Boyce, *Investing in Peace: Aid and Conditionality after Civil Wars* (Oxford: Oxford University Press, 2002), pp. 46-47.

First, it greatly limits the scope for revenue mobilization and development of domestic fiscal capacity. Second, it sends a clear message to the public that relatively rich and powerful people do need to not pay taxes, undermining future tax efforts. Third, it removes a policy instrument for seeking to manage the impacts of aid bonanzas on domestic labor and real-estate markets.

There are various avenues for taxing aid flows. Direct income taxes could be levied on expatriates and well-paid local employees. Indirect taxes, including tariffs and sales taxes, can be collected on goods and services purchased by the aid community, from imported vehicles and whiskey to hotels and restaurants. Taxes can also be levied on rental incomes on offices and housing space leased to aid agencies and personnel, using withholding taxes to facilitate payment. To its credit, the IMF on more than one occasion has backed these types of taxes and assisted in their design. The main stumbling block has been resistance from other donor agencies, including bilaterals and parts of the UN system. For example, when UN Transitional Administration in East Timor, acting on IMF advice, introduced taxes on contractors and providers of services to UN personnel, lawyers at UN headquarters in New York objected and sought to repeal them. Similarly, when the Karzai administration, again on IMF advice, proposed to aid contractors in Afghanistan, the US government threatened to reduce aid by double the amount of any tax collected.

The ability of host governments to tax the incomes of expatriate employees of UN agencies is constrained by the Convention on the Privileges and Immunities of the United Nations. But nothing prevents the IFIs (and other UN agencies) from voluntarily assenting to ‘payments in lieu of taxes,’ as a gesture of support for the goal of building domestic fiscal capacity. As in the case of expatriate employees of the World Bank and IMF in Washington, DC, who must pay US income taxes since the United States did not sign the Privileges and Immunities convention, salaries of the affected personnel could be ‘topped off’ with increments to offset tax liabilities, so that taxes are effectively paid by the agencies rather than by individuals. Given their economic mandates, it would be appropriate for the IFIs to take the lead role in addressing this issue.

**Recommendation:** *The IFIs should explore ways to tap incomes generated in postconflict aid bonanzas to prime the pump of domestic revenue collection, among other ways by negotiating payments in lieu of taxes for their own personnel and contractors.*

## 2. Peace conditionality

After the signing of a negotiated peace accord, the IFIs can support peacebuilding not only by helping to finance reconstruction, but also by using aid as a ‘carrot’ to encourage movement toward a lasting peace. In recent years, the IFIs have begun to experiment with peace conditionality – the use of formal performance criteria or informal policy dialogue to make aid conditional on steps to implement peace accords and consolidate peace – but these efforts have been constrained by lack of capacity and weak inter-agency coordination.

The term ‘peace conditionality’ was coined in a 1995 study of El Salvador commissioned by the United Nations Development Programme. The study recommended that the IFIs should use their leverage to encourage the Salvadoran government to take politically difficult but necessary steps to implement the 1992 peace accord, such as mobilizing revenue and shifting expenditure to fund the new National Civilian Police force and the Land Transfer Program for ex-combatants.<sup>34</sup> At the time, the IFIs were reluctant to address these issues, viewing them as ‘political’ matters beyond their mandate and competence. Soon thereafter, however, the World Bank’s *ex post* evaluation of postconflict experience concluded that ‘if tax effort and the pattern of public expenditures have a direct bearing on post-conflict reconstruction, as they did in El Salvador, it is legitimate to include these parameters in the conditionality agenda.’<sup>35</sup>

The principle of peace conditionality received high-level backing when World Bank President James Wolfensohn declared at a donors’ conference on Bosnia in April 1996 (in a joint statement with European Commissioner Hans van den Broek) that ‘developments on the ground should be constantly reviewed to ensure that aid is conditional on the thorough implementation of the obligations undertaken by all parties, in particular, full co-operation with the international tribunal for the prosecution of war criminals.’<sup>36</sup> In the following year, the IMF and World Bank withheld loans to Croatia until the government surrendered ten war-crimes suspects indicted by the International Criminal Tribunal for the Former Yugoslavia in the Hague.<sup>37</sup> During a visit to Guatemala in May 1997, a few months after the signing of that country’s peace accords, IMF Managing Director Michel Camdessus similarly declared that the key condition for an IMF stand-by agreement would be compliance with the peace accords.<sup>38</sup>

Responding to concerns that some types of conditionality may be construed as an intrusion on national sovereignty, a recent World Bank study argues that ‘conditioning aid upon adherence to the country’s constitution ... is potentially stabilizing and nonintrusive.’<sup>39</sup> The same logic can be applied to conditioning aid upon adherence to a negotiated peace accord.

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<sup>34</sup> *Adjustment Toward Peace: Economic Policy and Post-War Reconstruction in El Salvador* (San Salvador: United Nations Development Programme), report prepared for the meeting of the Consultative Group for El Salvador, May 1995; subsequently published as James K. Boyce, ed., *Economic Policy for Building Peace: The Lessons of El Salvador* (Boulder: Lynne Rienner, 1996).

<sup>35</sup> *The World Bank’s Experience with Post-conflict Reconstruction. Volume III: El Salvador Case Study*, 4 May 1998, p. 51.

<sup>36</sup> European Commission and World Bank, ‘Chairman’s Conclusions of the Second Donors’ Conference on the Reconstruction of Bosnia and Herzegovina,’ Brussels, 13 April 1996.

<sup>37</sup> For discussion of this and other applications of peace conditionality, see Boyce, *Investing in Peace*.

<sup>38</sup> Juan Carlos Ruiz Calderón, ‘Camdessus: La condición para certificar la economía es cumplir con los acuerdos de paz,’ *Siglo Veintiuno* (Guatemala City), 27 May 1997, p. 8.

<sup>39</sup> *Breaking the Conflict Trap*, p. 177.

Indeed in some cases, as in Bosnia, the constitution itself is established by the accord. More generally, peace conditionality does not represent a unilateral imposition of policies by external assistance actors; rather, it represents a ‘partnership’ between donor agencies and domestic actors who support the peace implementation process.<sup>40</sup>

One mechanism for institutionalizing peace conditionality would be to take the provisions set forth in peace accords as the basis for Interim Poverty Reduction Strategy Papers (I-PRSPs) in postconflict countries. This approach is mooted in a recent report of the World Bank’s CPRU which suggests, referring to PRSPs, that ‘outcome indicators may specifically address targets and agreements in peace accords.’<sup>41</sup> This year, with support from the British Department for International Development (DfID), the World Bank is initiating an effort to develop methods for the integration of conflict sensitivity into PRSP processes.

Effective implementation of peace conditionality will require investments in capacity building at the IFIs, so as to ensure that staff working in postconflict countries are attuned to the priorities of peace-accord implementation and prepared to make use of opportunities to advance these priorities by exercising peace conditionality. This will require closer coordination between IFI staff and international agencies directly responsible for peace implementation, such as the Office of the High Representative in Bosnia and the United Nations Verification Mission in Guatemala.

**Recommendation:** *To improve their capacity to implement peace conditionality – for example, by incorporating peace-accord commitments into Interim PRSPs – the IFIs should explore how their aid can be more closely articulated with steps to implement the accords and consolidate the peace.*

### 3. The legacy of odious debts

Postconflict countries often find themselves burdened with large external debts contracted by previous regimes. In many cases, a substantial portion of this borrowing was used to finance oppressors and oppression, rather than to benefit the country’s populace. In the current year, for example, the Democratic Republic of Congo is expected to devote more than 25% of government revenues to servicing the \$12 billion debt inherited from the Mobutu era.<sup>42</sup>

The case of Iraq recently has drawn greater attention to the question of how the legacy of such ‘odious debts’ ought to be handled. In international law, the doctrine of odious debt

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<sup>40</sup> See Boyce, *Investing in Peace*. See also John D. Ciorciari, ‘A Prospective Enlargement of the Roles of the Bretton Woods Financial Institutions in International Peace Operations,’ *Fordham International Law Journal*, Vol. 22, 1998.

<sup>41</sup> *Role of the World Bank in Conflict and Development*, pp. 14-15.

<sup>42</sup> See Léonce Ndikumana and James K. Boyce, ‘Congo’s Odious Debt: External Borrowing and Capital Flight in Zaire,’ *Development and Change* 29(2), 1998.

provides a basis for the repudiation of debts ‘contracted against the interests of the population of a state, without its consent and with the full awareness of the creditor.’<sup>43</sup> This doctrine dates from the Spanish-American War of 1898, when the victorious United States repudiated external debts accumulated by Cuba under Spanish rule. In words reminiscent of this earlier stance, US Treasury Secretary John Snow recently declared, ‘Certainly the people of Iraq shouldn't be saddled with those debts incurred through the regime of the dictator who's now gone.’<sup>44</sup>

The past year has seen proposals to establish a special international debt commission for Iraq that would examine all claims and to disallow debt that was used for state security or military aggression; and more generally, for the UN Security Council or an independent commission of international jurists to assume responsibility for assessing the legitimacy of regimes with a view to deterring future lending to regimes deemed odious.<sup>45</sup> The establishment of a transparent, internationally recognized process to bring future lending more systematically under the purview of the doctrine of odious debt would be a positive step, helping to deter irresponsible behavior by both borrowers and creditors. But this would not address the legacy of past debt burdens and the obstacles they impose on peacebuilding efforts today. And while the case of Iraq is distinctive in some respects, it is not *sui generis* with respect to the odiousness of the country's debts.

The IFIs could play a leadership role in addressing this issue. Rather than waiting for initiatives elsewhere in the international community, the IFIs could help to establish an independent body to lay the groundwork for the resolution of odious debts. Such a body could seek to define the circumstances under which debts can be classified as odious; analyze the implications of repudiation of odious debts for the functioning of international credit markets; and recommend policies for handling loans on the balance sheets of the IFIs themselves that could be classified as odious debts. This would require not only building legal capacity at the IFIs to define and identify odious debt, but also building financial capacity to sustain debt write-offs if and when these are justified.

**Recommendation:** *Building on precedents in international law, including the current discussions of Iraqi debt, the IFIs should establish a body to assess the possible scope and implications of initiatives to erase ‘odious debts’ inherited by postconflict governments.*

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<sup>43</sup> For discussion, see ‘Advancing the Odious Debt Doctrine,’ Montreal: Centre for International Sustainable Development Law, Working Paper, 2003. Available at <http://www.cisd.org/pdf/debtentire.pdf>.

<sup>44</sup> Quoted in Alan Beattie, ‘US in Push for Iraqi Debt Relief,’ *Financial Times*, 11 April 2003.

<sup>45</sup> These proposals have been advanced, respectively, by former US Treasury officials David Mulford and Michael Monderer, ‘Iraqi Debt, Like War, Divides the West,’ *Financial Times*, 22 June 2003; and Michael Kremer and Seema Jayachandran, ‘Odious Debt: When Dictators Borrow, Who Repays the Loan?’ *Brookings Review* 21(2), spring 2003.