

Economic Governance in War Torn Economies: Lessons Learned from the Marshall Plan to the Reconstruction of Iraq

Long Report

Prepared for



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GLOSSARY OF ACRONYMS

| | |
|----------|--|
| ADB | Asian Development Bank |
| AED | Academy for Educational Development |
| BiH | Bosnia and Herzegovina |
| BPD | Barrels per Day |
| BPK | Banking and Payments Authority of Kosovo |
| CISU | Central Intelligence and Security Unit |
| CNRT | National Council of Timorese Resistance |
| CPA | Coalitional Provisional Authority |
| CPI | Consumer Price Index |
| DAB | da Afghanistan Bank |
| DDR | Disarmament, Demobilization and Reintegration |
| DFID | Department for International Development |
| DM | Deutschmark |
| DPKO | Department of Peace Keeping Operations |
| DSRSG | Deputy Special Representative of the Secretary General |
| EAR | European Agency for Reconstructions |
| EC | European Community |
| ECA | Economic Cooperation Act |
| ECOSOC | United Nations Economic and Social Council |
| ECSC | European Coal and Steel Community |
| EEC | European Economic Community |
| EIU | European Intelligence Unit |
| ERP | Economic Recovery Program |
| EU | European Union |
| EURATOM | European Atomic Energy Community |
| FDI | Foreign Direct Investment |
| FEC | Far Eastern Commission |
| FMIS | Financial Management Information System |
| FRUS | Foreign Relations of the United States |
| FY | Fiscal Year |
| GDP | Gross Domestic Product |
| GOA | Government of Afghanistan |
| HIPC | Heavily Indebted Poor Countries |
| IBRD | International Bank for Reconstruction and Development |
| IDP | Internally Displaced Person |
| IMF | International Monetary Fund |
| INTERFET | International Force in East Timor |
| I-PRSP | Interim – Poverty Reduction Strategy Paper |
| JAM | Joint Assessment Mission |
| KEK | Kosovo Energy Corporation |
| KFOR | Kosovo Force |
| KLA | Kosovo Liberation Army |
| MEB | Micro Enterprise Bank |
| MEF | Ministry of Economy and Finance |

| | |
|----------|--|
| MFI | Micro Financial Institution |
| MPP | Mission Performance Plan |
| NATO | North Atlantic Treaty Organization |
| NDF | National Development Framework |
| NGO | Non-Governmental Organization |
| NSC | National Security Council |
| OED | Operations Evaluation Department |
| OEEC | Organization for European Economic Cooperation |
| OFF | Oil For Food |
| OHR | Office of the High Representative |
| OSCE | Organization for Security and Cooperation in Europe |
| PCE | Per Capita Expenditure |
| PIC | Peace Implementation Council |
| PISG | Provisional Institutions of Self-Government |
| RFP | Request for Proposal |
| SCAP | Supreme Commander for the Allied Powers |
| SCR | Security Council Resolution |
| SME | Small and Medium Enterprise |
| SOE | State-Owned Enterprises/Entities |
| SRS | Special Representative of the Secretary General |
| SWNCC | State-War-Navy Coordination Committee |
| TFHB | Trust Fund for Bosnia and Herzegovina |
| TSG | The Services Group |
| UN | United Nations |
| UNAMET | United Nations Mission in East Timor |
| UNAMSIL | United Nations Mission in Sierra Leone |
| UNDP | United Nations Development Program |
| UNECE | United Nations Economic Commission for Europe |
| UNHCR | United Nations High Commissioner for Refugees |
| UNITAR | United Nations Institute for Training and Research |
| UNMIK | United Nations Mission in Kosovo |
| UNMISSET | United Nations Mission of Support in East Timor |
| UNOMSIL | United Nations Observer Mission in Sierra Leone |
| UNRRA | United Nations Relief and Rehabilitation Administration |
| UNSAS | United Nations Standby Arrangement System |
| UNTAET | United Nations Transitional Administration in East Timor |
| USAID | United States Agency for International Development |
| USDA | United States Department of Agriculture |
| VAT | Value Added Tax |
| WB | World Bank |
| WFP | World Food Program |
| WLSG | Working Level Steering Group |
| WTO | World Trade Organization |
| WWII | World War II |

I. INTRODUCTION

This report addresses the issues of economic governance in war-torn economies. In particular it makes a case for the early delivery of technical assistance in economic governance for the reconstruction of economic institutions, for the establishment of sound economic policies, and for the creation of the capacity necessary for the sustainable functioning of a rebuilt state.

Often, there is a sense that what matters first in a post-conflict situation (after a political compromise has been struck) are emergency shelter, rural reconstruction, and refugee returnee programs. These are of course important, but they provide only an immediate assistance package that is not itself sufficient for improving economic governance or resolving the underlying conditions fueling conflict. Only more significant steps, to create conditions for economic recovery, employment, and growth, will put a country back on the path of development and resolution of fundamental factors that provoked conflict in the first place. Our central thesis is that economic governance, too, needs to be addressed from the early stages of post-conflict assistance. This is not only because such assistance is essential for alleviating underlying conditions that fuel conflict but also because a brief window of opportunity often exists at the outset of post-conflict assistance to make fundamental changes—a window that soon closes as various interests regain political power.

Our work covers economic development projects that have considerable US Government involvement (and in particular that of USAID after its creation in 1961). We have undertaken case studies on the following war-torn economies receiving assistance:

1. Germany after World War II
2. Japan and its reconstruction after World War II
3. Bosnia immediately after the Balkan Wars in 1995
4. Kosovo immediately following the NATO bombing campaign in 1998-1999
5. East Timor in 2000
6. Sierra Leone after its civil war.
7. Afghanistan after the October 2001 invasion
8. Iraq after the March 2003 invasion and occupation.

These have been selected since they cover the span of assistance and reconstruction from the inception of US reconstruction assistance to the present day in war-torn regimes. In each, we have reviewed the background to the delivery of assistance in the area of reconstruction and compiled lessons learned. We have not reviewed some very large USAID projects that have as part of their portfolio economic governance issues in places such as Egypt, Indonesia, Philippines, Central Asia, and the Caucasus. These, while informative and interesting, were not undertaken in a war-torn economy context and were not associated with the sense of urgency that has come with reconstruction assistance in combination with humanitarian, security and civil conflict that accompanies a war-torn aid effort.

Much like the Dobbins report for the Rand Corporation, *America's Role in Nation Building*, we are interested in the problem of comprehensive reconstruction of an economy in a war-torn context¹. The Dobbins report focuses more broadly on nation-building, and on security and ethnic issues. In contrast this report specializes in more detail specifically on economic governance, its successes and failures, the lessons learned, and the implications for future design of economic governance packages.

By “economic governance”, we mean the following:

Economic governance consists of the policies, laws, regulations, institutions, practices, and individuals that determine the context in which a country's economic activity takes place.

We are interested particularly in US Government-supported economic governance projects, how they have progressed, and what they have accomplished, as well as how they fit into the complex web of other bilateral and multilateral donor efforts.

One of the main purposes of this report is to inform donors on how to create an optimal reconstruction effort, such that no matter if there is one country or many, few donors or several, an economic reconstruction program can be designed that focuses the joint effort of all parties involved. By reviewing the lessons learned from each of the cases studied, we hope to be able to inform the design of reconstruction programs, to avoid repeating some of the more egregious errors made in past efforts, and to stimulate economic growth as soon as possible—even in adverse conditions.

¹ James Dobbins et al., *America's Role in Nation-Building: From Germany to Iraq*, 2003.

II. SUMMARY FINDINGS

During the era of post-World-War II reconstruction in Europe and Japan, the US, largely on its own, took a comprehensive reform approach that included well thought-out economic governance programs as part of the overall reconstruction effort, covering a wide range of economic governance issues and not just reconstruction of physical infrastructure. In contrast, many programs implemented by the US Government after the Marshall Plan and the Reconstruction of Japan did not place economic governance at the center of the rebuilding effort, implicitly not viewing economic governance as one of the core components necessary for rebuilding a society, along with the other essentials of emergency shelter, rural reconstruction, and refugee returnee programs. In contrast to many reconstruction efforts undertaken in the post-War decades but consistent with the philosophy of the reconstruction effort in Europe and Japan, it is our view that, when economic governance issues are addressed early and consistently, the chances for rebuilding a war-torn country are enhanced.

While immediate and consistent attention to economic governance is a necessary condition for success, it is not a sufficient condition. Economic governance programs must be part of the initial sequence of reconstruction, and the programs should represent an investment by the main donors. Additionally, specific economic governance tasks need to be accomplished. In the absence of this, the reconstruction efforts can more easily falter, making more likely the re-emergence of poverty, civil war or both.

An important question considered is how best to organize and structure reconstruction assistance. In some cases, efforts have been undertaken almost exclusively by one donor (usually the US), while in other cases joint efforts have included several multi- and bi-lateral donors. The success of organization of a reconstruction effort seems only partially related to whether one donor manages reconstruction or several. The US-led efforts in post-War Germany and Japan were generally viewed as effective, while the US-led role in Iraq has received more ambiguous evaluations. The multi-lateral effort in Bosnia has been said to be not well coordinated, while subsequent multi-lateral efforts in Kosovo and Afghanistan generally have been judged to be better coordinated. What seems to matter more is not whether one donor or several lead an effort, but, rather, whether the effort is organizationally well planned and well structured, with a streamlined hierarchy of command, regardless if one or more donors are contributing to this organizational structure.

In addition to looking at the structure of reconstruction efforts, we also consider issues of preparedness, capacity building, prioritization of various economic governance issues, political and security concerns, and the content of assistance in a number of specific economic governance areas.

The summary table presents the lessons that are to be learned from the post-conflict reconstruction experiences of post-World War II and more recent efforts.

TABLE II.1: SUMMARY OF LESSONS LEARNED

LESSONS 1-13

GENERAL LESSONS IN ECONOMIC GOVERNANCE

1. Preparing for the post-conflict period should begin early, while the conflict is still under way, and include the participation of various likely donors, as well as representatives of any national organizations likely to play a role in the post-conflict government.
2. New, post-conflict governments and donor presence should be well integrated and structured to address their tasks, rather than merely reflecting underlying political tensions and donor cultures
3. Even at the initial reconstruction stage, growth and job creation should be expected to come from private-sector-led growth, not government/donor spending.
4. Security is essential for reconstruction and for economic development
5. Post-reconstruction efforts need to prevent organized (and unorganized) crime from monopolizing economic sectors and from creating a lawless environment that threatens legitimate business.
6. The economic reform agenda predating the conflict needs to be addressed early in the reconstruction effort, or underlying issues that contributed to the conflict situation will continue to fester.
7. Lack of resolution of final political status impedes reconstruction and economic growth.
8. Early programs in reconstruction need to focus on key political and social constituencies—including social programs to help most vulnerable population groups, benefits for veterans and decommissioned soldiers to give them a stake in the new society.
9. Building new institutions for economic governance takes time and should begin early in the reconstruction process.
10. Training and educating individuals for economic governance also takes time and should begin early in the reconstruction process. Training in rote tasks, such as processing business licenses or managing a treasury system, can be taught through on-the-job training. However, educating a professional class of analysts and policymakers requires multi-year graduate education programs, either in-country in newly redesigned local graduate education programs or abroad.
11. A modern policymaking process needs sound economic data, which requires considerable investments by donors to develop.
12. High priority and time-consuming activities should be sequenced to begin towards the start of the reconstruction effort.
13. The period at the very start of reconstruction, while difficult and often chaotic, is also an important window of opportunity to undertake politically difficult reforms and institutional changes—an opportunity that, if lost, might not reappear during the reconstruction process.

LESSONS 14-26
THE PILLARS OF SOUND ECONOMIC GOVERNANCE

14. Prior to setting monetary and exchange policy, a post-conflict country often needs to create the instruments for setting and implementing policy: a money in circulation, a foreign-exchange market, market data on prices and exchange rates, and a policymaking process in an independent central bank (or equivalent).
15. Exchange-rate and inflation policy must balance the need for stability with the need for competitiveness of exports, actively responding to neutralize the impact of large donor inflows and other post-conflict macroeconomic phenomena.
16. Inflation policies should bring inflation rates down to low, stable levels, while still allowing for adjustments in relative price levels.
17. In financial sectors, policies should focus on the basics of creating a payments system and of establishing a rudimentary regulatory regime over a private banking industry, while leaving the cultivation of more sophisticated financial market institutions to a later stage in development.
18. Creating or improving systems of budget execution is the first priority for expenditure policy, even before developing a budget preparation process.
19. Tax policy should evolve along with the capacity of tax administration, starting with simple indirect taxes like presumptive taxes, and developing toward more complex indirect taxes like the value-added tax.
20. Capital expenditures and investment projects should be integrated into a comprehensive state public investment program and capital budget.
21. Institutions need to be built to address each country's specific trade issues, creating foreign demand for domestic production.
22. Basic commercial laws and institutions are necessary for jumpstarting private sector development.
23. Social policy must evolve into well targeted efficient programs for those most in need, either from scratch or from pre-existing programs that were poorly targeted or based on political privilege
24. Countries that have a history and expectation of generous pension programs should move quickly to institute a modern pension system rather than back sliding into recreating the old pre-conflict system.
25. Gender and women's issues often are particularly important in post-conflict situations, not only because the welfare of women often has been particularly disregarded during conflicts.
26. Appropriate sectoral policies should provide public goods where needed, particularly in infrastructure areas, without creating distortions, "picking winners," or helping some sectors at the expense of other sectors.

III. WHY ECONOMIC GOVERNANCE MATTERS

In most post-conflict countries, economic governance issues are inextricably intertwined with security and political issues. In most cases, pre-existing economic conditions have contributed to a conflict situation, either by giving unusual economic power to certain groups in society, some of whom instigate conflict, or by depriving certain other groups in society from economic opportunities, thereby disenfranchising them and causing hostility toward pre-existing institutions. Poor economic governance has contributed to causing the conflict in the first place, so good economic governance is important to resolving it. Sound economic governance that promotes equitable, sustainable growth is the key to remedying underlying tensions in society, allowing a country to put conflict in the past and move forward with economic development. Failure to establish good economic governance after a conflict greatly limits the possibilities for making changes in the underlying social relations that led to the conflict, thereby increasing the chances of continued or renewed conflicts.

While economic governance often is not the very most important cause of conflict, it usually is among the top several causes. And economic governance is one of the areas where meaningful progress can be made over a period of a few years. Many political conflicts arise most fundamentally because of ethnic hatreds or competition between two peoples for one land or for other scarce resources. Only secondarily are they due to reasons related to economic governance. Nonetheless, really reducing ethnic tensions is a task for generations, if not longer; whereas, meaningful progress with economic governance can be made over a relatively shorter period, with sufficient resources wisely spent. For instance, efforts to restart economic activity both in Japan and in Europe were successful in a short number of years. Truly building democratic traditions with strong civil society took far longer. Also for instance, in an example from the modern period, in Kosovo, efforts at building a modern tax regime and a new pension system achieved success quite quickly, building at least some semblance of a normal society with a fiscally sustainable base. Efforts to really address deep-seated ethnic tensions have been less successful, probably requiring still many years of work. While these improvements in economic governance in Germany, Japan, and Kosovo have not been the only factor in keeping the peace after the conflict, they have been at least one important factor, and a failure to achieve some improvements of economic governance in these cases might have led to further political destabilization.

Examples of the importance of economic governance can be seen in each of the case studies: the Marshall Plan, Japan, Bosnia, Kosovo, East Timor, Afghanistan, Sierra Leone, Iraq. The most significant aspects of the Marshall Plan were economic reconstruction and European integration.

Under the Marshall Plan, for example, resources were allocated to restarting production in each country. Means for effective budget execution were created, including local-country decision-making in procurements funded by donor monies. Programs carried-out

under the Marshall Plan emphasized production and integration of countries into a continent-wide economy. An intra-European payments system was created to facilitate inter-country trade. The German economy was reformed and put on a fiscally prudent path through the Erhard Plan. This vision of post-war reconstruction stood in sharp contrast to the policy of punishing Germany after World War I. Not paying attention to the “economic consequences of the peace” in Germany at Versailles in 1919 by focusing on retribution rather than rebuilding exacted a heavy toll on Europe and is an early lesson in what happens when those states responsible for reconstruction of a war-torn economy focus on goals other than economic governance.

The impact that these initial acts linking European economies together had on the course of world history cannot be exaggerated. (See box.) After centuries of intra-European wars, from this moment onward, Europe has moved toward ever closer economic and political integration. First were created narrowly targeted institutions of cooperation and then broader institutions, culminating in establishment of the EU and its subsequent expansion eastward.

In Japan prior to World War II, concentration of industrial assets in the hands of militarists gave them the wealth necessary for waging a major world war. Breaking up these industrial concerns (the *zaibatsu*) and creating a relatively open, competitive environment was critical for breaking the power of the militarists in society and for giving other social groups a stake in the newly restructured economy. Although concentration of industrial ownership remains a problem with the economy of Japan to this day, the Occupation reform efforts nonetheless made considerable strides to create more competition than that found in the pre-war period. It achieved this by liquidating a number of the most influential *zaibatsu* and reducing concentration of ownership in large firms by transforming them from being held by a few wealthy families to being publicly traded and held by employees and others. Also, modern competition policy was introduced to make illegal various anti-competitive and monopolistic practices. (Much of German industry had been nationalized during the war but was not concentrated into conglomerates in the same way it had been in Japan.)

Box III.1: History of European conflict and integration post World War II

- 1948** Economic Cooperation Act (Marshall Plan) enacted.
- 1950** European Coal and Steel Community (ECSC) established.
- 1957** Treaties of Rome signed, creating the European Economic Community.
- 1967** EEC combined with ECSC and European Atomic Energy Community (EURATOM) to form unified European Community (EC).
- 1992** Maastricht Treaty signed, adding inter-governmental cooperation and creating European Union.
- 2004** Ten new member-states joined the EU.

In Bosnia, some important gains were made initially in providing emergency assistance and helping the country to return to normalcy. Nonetheless, very partial progress was made in creating a unified state and common economic space, and, with time, the opportunities for continued progress along these lines have become even more limited, reducing the prospects for sustained growth in Bosnia.

In Kosovo, great strides were made in the early years after the conflict with reconstruction of physical capital (particularly the housing stock) and with building much of the legal and institutional foundation for a market economy. In many cases, these efforts could be considered development (of something new) rather than reconstruction (of something old that had been destroyed during the conflict), as many of these institutions had not existed even before the conflict, during the period of Yugoslav socialism. New legislation was enacted on company law, contracts, pledges, procurement, and a host of other areas. A modern tax system emphasizing indirect taxes (VAT and customs) rather than labor-based taxes was created. A modern pension system with personal funded retirement accounts was established. And new institutions related to economic governance were created—budget and macro analysis units in the ministry of finance, tax and customs administrations, a central bank, and modern private commercial banks.

In some areas in Kosovo, less progress was made, so when we suggest a successful reconstruction effort versus a less successful effort we have to be aware it is always a question of degree. For example, even in Kosovo which we consider to be a success in economic reconstruction, a lack of resolution of final political status has made the future of property rights unclear, contributing to an unwillingness of investors to invest there. Inadequate macroeconomic management and failure to open regional trade opportunities have resulted in poor economic performance of the domestic economy outside of donor-related activities, little creation of jobs, and little economic opportunity for Kosovars. Unchecked crime has further exacerbated the situation. This lack of economic opportunity partially contributed to rising tensions that recently spilled over into renewed ethnic conflict between Albanians and Serbs in March 2004. As another example: before the conflict, Kosovars had developed a culture of non-payment of taxes and other fees (such as electricity bills), as a means of fighting against the incumbent regime. While a helpful strategy in combating oppression, in the post-conflict environment, this ingrained culture of non-compliance has set back efforts to establish sound economic governance, for instance in activities aimed at creating a profitable electricity company and a broad tax base. (Similar non-compliance characterized much of Kurdish economic activity in Iraq.)

In Afghanistan, too, with USAID support, considerable steps have been made both with physical reconstruction and with a market-oriented development agenda. However, limited progress in building a centralized system of state expenditures has paralleled limited political progress in establishing authority of the national government over the regions. The inability of the central government to ensure remittance of revenues collected in the regions to the center, and to monitor and control state expenditures, has contributed to the extent to which the regions do not hold themselves accountable to the

central government. This is a chicken-and-egg problem: Because the central government has little political control over the provinces, Kabul is unable to compel the provinces to remit revenues; but if the national government had better control over the finances currently controlled by provincial governments and warlords, then the center would have stronger political reach as well. That said, Afghanistan, in relative terms, is one of the more successful war-torn reconstruction efforts—largely because of their strict adherence to their National Development Framework (NDF). That is, to a large degree Afghanistan has achieved the limited success it has because Government spending and also spending by the donor community has followed the priorities set in the NDF, making sure the whole development effort is coordinated around key priorities.

In East Timor, success with restructuring the public sector at the beginning of the post-conflict period (by greatly reducing the number of staff positions in state organizations) created the foundation for a sustainable fiscal policy. Low tax rates conducive to economic growth would yield sufficient revenues to cover a portion of state expenditures. Budget deficits have been covered with World Bank managed donor trust funds, until future oil revenues come on stream. These factors, along with community-based reconstruction and a significant international presence, contributed to the relative economic development East Timor experienced during the immediate post-conflict period.

In Sierra Leone, assistance has focused on bringing the diamond trade into the formal sector, out of the shadow where it has provided financial resources to warring parties. These activities aimed at breaking the mechanisms by which economic activity funded violence can be seen as similar to the efforts in Japan to break up and change ownership of the *zaibatsu*, also breaking the link between economic production and militarism.

In Iraq, several factors have impeded resumption of economic growth. The security situation in many parts of the country has been inadequate for allowing the resumption of many basic economic activities. Furthermore, Iraq's ubiquitous Oil-For-Food (OFF) programs created a dependence on subsidized imported food distributed to Iraq's domestic markets, sharply reducing demand for many domestically produced goods². This gave government officials and distributors unusual power over allocation of the economy's resources. The negative impact on the domestic economy of OFF programs started when these programs were introduced in collaboration with the UN, long before the conflict, in the mid-1990s. After the conflict, OFF programs were transferred from UN to Iraqi government auspices, modified somewhat to increase some domestic purchases and reduced in overall budget size. Nevertheless, these programs continue to lead to purchase of billions of dollars of imports annually that are distributed almost for free on local markets, harming domestic production.³ The negative security situation and failure to date to replace OFF programs with monetary subsidies greatly contribute to

² A typical food basket consisted of wheat, rice, pulses, vegetable oil, sugar, milk, salt, tea, soap, detergent, most of which had been produced in Iraq. DFID, "Restructuring Iraqi Consumption: Transition from Handouts to Markets."

³ Christopher Foote, William Block, Keith Crane, and Simon Grey, "Economic Prospects and Policy in Iraq," *Journal of Economic Perspectives*, vol. 18, no. 3, Summer 2004, p53.

unemployment and idleness of the population, while also creating opportunities for corruption in the administrative allocation of OFF resources. Factors such as lack of security and subsidies like OFF programs that hinder domestic production and employment can raise social tensions and increase likelihood of renewed social conflict. (Given that Iraq faces both security concerns and OFF programs, it is not readily apparent how much further unemployment and stagnation is caused by the OFF programs beyond what would result merely due to the difficult security situation.)

In all post-conflict countries, as is the case elsewhere, macroeconomic stability, sound fiscal policy, and other institutions and policies that promote private sector development, are central to creating jobs, reducing numbers of angry unemployed, and giving the population a stake in a new society. In each of the post-conflict countries, improvements made in economic governance have contributed to relieving underlying social tensions, and lack of progress often has been a factor when social tensions have bubbled over into renewed conflict.

Furthermore, as noted earlier, many key reforms are politically challenging and therefore best undertaken immediately, while potentially opposing interests still are relatively weak. It is hard to imagine how in Kosovo so many laws could have been put through later in the reconstruction process, or in Afghanistan such a good public expenditure information system created, or in East Timor such downsizing in public administration achieved, or in Japan breaking up of the *zaibatsu* accomplished, if these reforms had been postponed for a later phase. Similarly, in Iraq, failure to quickly convert Oil-for-Food into monetized subsidies during the brief period of Coalition rule might turn out to be a key shortcoming, leading to continuation of a fundamental distortion in the economy—if relatively powerful governments immediately following the end of conflict are unable to implement hard reforms, it seems likely that subsequent governments, with even more tenuous a grip on power, also will be even less able to undertake hard steps such as reform of Oil-For-Food into a market-based system.

An important point this study makes is that the early introduction of well-targeted, comprehensive economic governance programs are essential to utilizing what becomes within a few years of reconstruction, scarce donor money. Ron van Rooden of the IMF, in commenting on the reforms in Afghanistan, has made an important observation on this:

Another risk [jeopardizing the reconstruction effort and insuring political stability] is that external assistance may fall short of what is required. The experience of post-conflict countries shows that assistance typically starts to decline after a few years, just at the moment when the recipient country's capacity to absorb aid and use it effectively is increasing.⁴

There are two important issues raised here by van Rooden and central to the problems of reconstruction in war-torn regimes.

⁴ Ron van Rooden cited in IMF, *Islamic State of Afghanistan: Rebuilding a Macroeconomic Framework for Reconstruction and Growth*, 2003 pp. 12-13.

First is the issue of having in place a system of economic governance institutions to absorb and properly channel external assistance—such that it is not wasted on white elephant capital projects that the current budget could never hope to finance over the long run. In most war-torn economy reconstruction efforts, as we discuss in each case study, the ability of their economies to absorb external assistance and to fully utilize the contributions to capital investment are a function of their ability to manage the funds they are offered. The more quickly a central fiscal authority and a central bank are established that can intervene to impose financial stability, as well as a legal and regulatory structure to allow the proper functioning of property rights, the more the regime can get out the early money poured in by donors.

Second, almost as important, is the ability to avoid donor-fatigue and seek additional funds when they may be most important. The sooner the institutions of economic governance are established and up and running, the sooner the recipient country can justify, explain and thus seek additional donor funds. The closer the budget and financial reporting of the recipient state is to international standards, the more likely it will be to make its case to steering committees consisting of donor representatives in order to receive needed infusions of funds⁵. This was an important lesson in Kosovo for the author, who was Co-Head of the Department of Reconstruction, and Alan Pearson, who was Co-head of the Central Fiscal Authority. We spent several weeks preparing reports for the Working Level Steering Group (WLSG) Committee that reviewed donor allocations to Kosovo, so that all donors felt confident their money was being well spent, so that they could easily justify it to their constituents at home, and so that the reporting they received from us (in Kosovo) on the use of funds could withstand an audit in their home countries.

In contrast, in Iraq, non-US donors seemed skeptical of the CPA's ability to manage large sums of donor contributions efficiently and transparently. This concern partially contributed to a reluctance on the part of other potential donors to make financial contributions to a centralized spending process.

The implication here is that if donor money to the recipient state is going to decline after a few years anyway—then there is every reason to set up economic governance institutions to maximize its use. However, if there is any way to insure a continued flow of funds by avoiding “donor-fatigue,” it will only be through having in place a proper set of economic governance institutions donors can rely on.

⁵ For an example of preparation materials for the Working Level Steering Group Committee on Kosovo, see Stephen Lewarne and Alan Pearson, Co-Heads, Department of Reconstruction and the Central Fiscal Authority Final Report, BearingPoint 2000 Kosovo I Project.

IV. ECONOMIC RECONSTRUCTION IMMEDIATELY AFTER WORLD WAR II AND TODAY

There is a growing literature on the Marshall Plan's applicability to today's reconstruction needs. Several journalistic observers have made unconvincing cases of their incompatibility, citing differences in culture and assuming institutional and legal infrastructure in post-war Europe and Japan that simply was not there at the time (but is now). A serious attack on the Marshall Plan application in recent times comes from Barry Eichengreen. He makes an interesting case for the fact that the Economic Cooperation Act (ECA) money merely tipped the balance in the economies of Europe, which were at that time starved for capital in an international capital market that was segmented. Today, he claims, with capital markets so free, it is unclear that a Marshall Plan style would have the required impact, and that, in fact, it would represent a waste of tax dollars. Eichengreen's assumption of free capital markets does not apply in war-torn economies or in underdeveloped states such as Sub-Saharan Africa (he notes the latter location). In fact capital markets do not work that well in North Africa either, nor in Iraq, Afghanistan, Kosovo, Bosnia or any other War-Torn or fragile state where a Marshall Plan would be considered.

In the end, commentaries that focus on specific technical issues such as capital markets overlook broader important issues, which are the organization of the effort, the goals and the funding mandate behind the effort. Few people would have said at the time that post-war Japan's imperial structure was anything like the US legal system—least of all McArthur and his legal team who wrote the new laws. In fact several commentators note how foreign the new legal process being developed for Japan was at the time. Fewer still cite any bankruptcy, court proceeding or welfare distribution functions in post-War Germany. Even with entrepreneurialism and public-private cooperation, the task was daunting: trying to re-build a capital stock of much greater magnitude than what capital needs are today even in Iraq. Thus, while the problems are different, they are all large in their own way, and they all require focus and organization.

A major thesis we put forward is that reconstruction efforts under the Marshall Plan and Japan 1) were focused, well thought out and planned, 2) were on economic governance issues as much as humanitarian, security, and physical reconstruction programs and 3) lacked a competitive nature with other donors as aid does today. This allowed for the war-torn economy to recover much more rapidly and require less assistance in the out years. Of course, external factors also played a role in rapid recoveries. For example, the start-up of the Korean conflict created considerable demand for Japanese goods and services, and similar increases in world demand helped fuel Europe's post-War growth

An important difference between the Marshall Plan era and more recent reconstruction efforts, in terms of organizational structure, is the way assistance was organized then, all under the auspices of one donor—the US, vs. now under joint efforts of many bilateral and multilateral donors. Under the Marshall Plan and in Japan, the U.S. was the final authority and the main and direct source of funds. However as we point out, this was not

the main factor in determining success in these early reconstruction efforts. It certainly helped and, we would contend, allowed for faster recovery once problems were addressed, but even under one authority, there were problems. What is of real interest is how the Truman Administration, when faced with division and squabbling between departments, worked to resolve the issues and restore the advantage of a single donor decision-making process.

If we compare the effort of the Marshall Plan with that of Iraq, we note a similar problem at the start of each. Both reconstruction efforts took over a year to get off the ground and were characterized initially more by infighting between the State Department and War (Defense) Department than with real economic development. As Michael Hogan has pointed out in his history of the Marshall Plan (before even the first Iraq conflict occurred):

...previous aid programs had failed and would continue to fail so long as American assistance was used in piecemeal efforts to revitalize national economies. The squabbling between the War and State departments was symptomatic of the drawbacks inherent in uncoordinated aid programs. Worse still, the piecemeal approach seemed to be perpetuating the very order that had hampered economic growth and led to German domination in the prewar period.⁶

This problem of uncoordinated, unfocused assistance was quickly corrected by President Harry S. Truman, who admitted mistakes, brought in a prominent leader from another Party (Herbert Hoover) to assess the situation, gave considerable leeway to junior but very talented staff in the State Department under Dean Acheson and George Kennan, and asked for a new plan to more efficiently use aid⁷.

It is of importance that the Marshall Plan had this problem and that it was resolved only after about 18 months. We have seen in Iraq, that a similar period of 18 months has passed, but such a solution does not seem imminent. The question that puzzled us as authors is why did this have to occur in Iraq when we already knew it had happened under the Marshall Plan? One answer is that, there will always be start-up problems, and they can last anywhere up to a year or two for very large efforts. The issue is not start-up lags, rather the ability to self-correct. The Marshall Plan, after 18 months, did a review and then availed itself of all USG resources on economic reconstruction and planning. The CPA—as we discuss below—did not use USAID resources as effectively as it could have. This is why the Marshall Plan was able to self correct, and why we believe the Iraq reconstruction effort is still beset with problems 18 months after the end of the conflict.

⁶ Michael Hogan, 1987 p.35.

⁷ Quoting from Michael Hogan (1987 p. 33-34): “His [Hoover’s] report issued in march 1947 recommended lifting the restrictions imposed by the level-of –industry plan, halting the removal of non-military industrial plants, and allowing the Ruhr and the Rhineland to remain parts of Germany. These revisions in policy, it maintained, would leave Germany with the factories and resources needed to increase production and thus spare American taxpayers the onerous expense of supporting the German population. Together with the proper safeguards against renaissance of German militarism, they would also permit Germany to contribute to the peaceful stabilization of Europe as a whole.”(see also Truman letter to Hoover, January 18, 1947, Hoover letter to Truman, January 19, 1947 and Hoover letter to Truman March 18, 1947 and Herbert Hoover, *An American Epic* 4 vols. (Chicago 1959-64).

Under the Marshall Plan the US also had been planning for occupation and reconstruction well in advance of the cessation of hostilities. Start up problems did occur, as we discuss in the case studies below, but they were not fatal flaws and were possible to overcome by an Administration in Washington that was willing to consider debate and criticism from several quarters, review its original objectives and quickly organize around a solution.

We believe therefore, that the underlying factor in success of a war-torn reconstruction effort is not the lead and dominating participation of the US, but rather the fact that the development effort is focused through a unified organizational structure and an explicit national development framework, that the budget is used as much as possible as a document to guide policy, and that the ruling government—be it a new one or an occupier—relies on the services of those development agencies at its disposal to achieve its collectively agreed goals. What is important is for reconstruction planning and implementation to be well organized and coordinated. While this most easily can take place when one country or agency oversees or clearly leads all reconstruction work (as in the case of the Marshall Plan and Occupation of Japan), there are examples of well organized aid efforts led by several donors (Kosovo, Afghanistan, East Timor), and also an example of a less well organized effort led by one donor (Iraq).

Thus it is tempting to credit the success of these early aid years relative to later years to the singularity of U.S. purpose and to the fact that one government was acting alone as opposed to several donors and aid agencies working together. However, although the primary role played by the U.S. may have had something to do with these early successes in Europe and Japan, we will show that a number of later reconstruction efforts beginning with Kosovo in 1999 involved several donors and managed to be successful. And Iraq is an obvious case where we feel it has not gone so well.

Another fundamental difference dominates the two eras in the delivery of reconstruction assistance: a universal approach, characterized by consolidated funds in one administrative pot to be drawn on, in the same way a budget process works, versus today's approach of multiple donors competing with one another (UN,EU,WB,IMF, and bilateral assistance bureaucracies). In many cases donor assistance programs are a diversified patchwork without a consistent theme. In addition, in a number of reconstruction efforts since those immediately after World War II, there has been an apparent lack of strategic interest in the reconstruction effort beyond humanitarian assistance and conflict resolution—as opposed to the Marshall Plan and the Japanese Reconstruction program, which prioritized rebuilding economies and institutions of economic governance. The early efforts of the Marshall Plan and Reconstruction of Japan also had bold, blunt statements about promoting US economic interests globally and ensuring that the largest economy in the world would benefit from its aid in terms of strong economic partners in Europe and Japan. To state these goals explicitly today is seen as anathema, with the consequence that the aid delivery gets watered down to often nominal consequence.

Over the last few decades we have seen a move into attempts at more international cooperation, where responsibilities and tasks are divided up among different types of

donors and often long time lags result in aid delivery. Certainly in assistance offered to West Africa and later Kosovo, we see this splitting of responsibilities. Reconstructions in Kosovo, East Timor and Afghanistan have been cooperative efforts of many multinational donors and are rated very highly. In the cases of Kosovo and Afghanistan especially, the planning processes were well coordinated and integrated aid packages were introduced early-on. These reconstruction efforts learned lessons from their predecessors and largely recreated the unity of purpose seen in the Marshall Plan,

Kosovo is a case study in the mix of good policies in economic governance (introduced by USAID) but bad governance (in general mostly by the UN). There are clear lessons learned between Kosovo in 1999 and East Timor in 2000 where the entire “pillar approach” used in Kosovo (whereby each major donor was given a “pillar” of the bureaucracy) was abandoned, and instead more efficient forms of donor assistance were used, including adoption of a single budget process through which capital investments were run⁸. Nonetheless, on balance Kosovo’s economic governance package was well introduced early on and reasonably well planned in advance.

The case of Iraq, the most recent major reconstruction effort of those we consider, merits particular attention, when compared with the experiences of the Marshall Plan era. The reconstruction process carried out under the Marshall Plan is now considered to have been a classic example of successful reconstruction carried out by one donor, the USG. The administration of the Marshall Plan after World War II was carried out after the first year by a streamlined, unified State-War-Navy Coordination Committee. The Iraq construction, considered to be principally led by the USG, would lead one to expect a successful outcome in the tradition of the Marshall Plan. However, we find that unified planning under one entity is only a necessary, not a sufficient condition. For example, reconstruction in Iraq has been directed by the CPA, although multiple countries (U.S., Britain and Australia) have participated in the effort. The CPA did not rely on an integrated team, but relied on a team drawn from various organizations across government—Department of Defense, NSC, Department of State, USAID, Treasury, Department of Commerce, USDA, and the NSC— with different operating styles and procedures. There was no streamlined organization within the lead donor (i.e., within the relevant U.S. Government agencies) and little utilization of development specialists in economic reconstruction. Lessons from those efforts highlight the importance of effective coordination in both planning and implementation. Further, as already stated, it has been some 18 months since the start of reconstruction and unlike the Marshall Plan, we see no similar review of aid operations as occurred under Truman with the Hoover report (yet we acknowledge this still may occur in Iraq; it just has not happened yet).

It is also often stated that the US did a better job in Europe under the Marshall Plan than in more recent reconstruction projects such as Bosnia, West Africa and Iraq, because the country then was more willing to dedicate more resources to the problem in order to:

- Assist our war-time allies

⁸ S. Lewarne, *Capital Budgeting in Kosovo*, Memo to USAID December 1999. See also UNITAR, *The United Nations Transitional Administration in East Timor (UNTAET), Debriefing and Lessons*, Martinus Nijhoff Publishers, 2003.

- Come to the aid of Christian nations
- Fight communism
- Provide assistance to our forefathers' nations and historical brethren

While this did play a major role in the debate in Congress (see the case study on the Marshall Plan), it is important to note that we in fact spent *less* under the Marshall Plan than we do on aid today, per capita (in real dollars), at least in some of the post-conflict situations, in seemingly far-off lands of non-European peoples.

Dobbins provides a useful comparison in his recent work for The Rand Corporation. Germany received about \$200 per capita (in constant 2001 \$US) during the first two years after the conflict. Kosovo received about \$800 per capita, Bosnia over \$1,400 per capita, and Afghanistan less than \$100. A key conclusion of his is: “Many factors influence the ease or difficulty of nation-building: prior democratic experience, level of economic development, and national homogeneity. However, among the controllable factors, the most important determinant seems to be the level of effort—measured in time, manpower, and money”⁹. His comparisons measuring aid resources per capita are only partially useful. While it is generally true that, the more one pays, the more one gets, it is also true that many country needs are independent of population size. The cost of achieving many objectives will be the same regardless of how large a country is. For instance, purchasing an expenditure management information system, or training a macroeconomic unit, costs roughly the same in a place of two million (Kosovo) as it does in a place of 30 million (Afghanistan).

There was considerable learning between Bosnia and Afghanistan by all donors. It was only after mistakes in Bosnia on coordination and after USAID’s comprehensive umbrella economic governance project in Kosovo that we see more rapid attention paid early-on to establishing economic governance institutions. By the time reconstruction efforts in Afghanistan started, the IMF, the ADB and the UN had learned enough to act immediately after the Bonn Agreement (November 2001) to start economic governance institutions more rapidly. Even then, assistance in this area was slow and came after the standard humanitarian assistance—but it was better than before. To some extent, the experience in Iraq, in terms of planning ahead of time, utilization of that planning for implementation, and coordination among government agencies, occurred at pre-Bosnia standards, not taking advantage of the lessons that had been learned in the experiences of Kosovo, East Timor and Afghanistan.

A comparative table has been constructed in the Annex to the Case Studies to show the detailed relationship between USAID’s Economic Governance Programs in Kosovo, Afghanistan and Iraq. They are illustrative in that they have clearly built on one another and, when viewed in light of the history of economic governance, show a clear programmatic picture of what is necessary. Unfortunately many of the programs have been hindered by local circumstance, bad donor coordination, an absence of a functioning government, or a government that simply will not accept an entire package.

⁹ Dobbins, 2003 p.xxv.

V. NOTEWORTHY EVALUATIONS OF POST-CONFLICT RECONSTRUCTION EFFORTS

A number of analyses have been written of post-conflict reconstruction efforts. In most cases, these analyses have focused more on political and security issues, and less so on economic governance, and they have tended to evaluate post-conflict experiences from the perspective of a single institution's role (for instance the UN). The following is a brief overview of several analyses that are most relevant for the present paper.

Post-conflict reconstruction in Japan, Korea, Vietnam, Cambodia, East Timor, and Afghanistan, Proceedings of an International Conference, UN Institute for Training and Research, Hiroshima, 2002. Practitioners and experts familiar with these reconstruction efforts gathered to draw lessons. Lessons drawn noted improved capacity among donors to work together and coordinate in post-conflict environments. They also noted the importance of recognizing that post-conflict situations differ from other development conditions, requiring better implementation capacity on the part of donors since local governments' capacity was lower. Too much bias was noted toward external actors rather than local actors, and toward government action rather than development of private sector actors. The need was noted for more emphasis on rebuilding trust and belief in the future of society among the local population. Most post-conflict reconstruction efforts were judged as needing better recognition of how hard the task is, how competent implementation has to be, and how long the process needs to be. Insufficient resources were judged to have been allocated for capacity building. Other needs identified include establishing security, justice, democratic governance, and socio-economic opportunity. Financing issues also were deemed important—delivering promised assistance efficiently and on time. Progress was noted in financing as of the experiences in Afghanistan and East Timor, with an over-arching budget determined early in the process, unification of financing flows in multilateral trust funds, early engagement of donors, and early delivery of at least some pledges. Other than the issue of financing, lessons did not focus on economic governance.

Panel on UN Peace Operations (the “Brahimi Report”), August 2000. The UN constituted a panel to review its own peacekeeping operations, led by the highly respected Lakhdar Brahimi. This report reviewed how the UN had prepared, organized, and implemented its recent peacekeeping operations. The report looked broadly at many factors related to success or failure in peacekeeping operations, including political, security, and economic issues, as well as organizational and resource matters. Among its finds are the following:¹⁰

- “No failure did more to damage the standing and credibility of the United Nations peacekeeping in the 1990s than its reluctance to distinguish victim from aggressor.”
- “The Secretariat must not apply best-case planning assumptions to situations where the local actors have historically exhibited worst-case behavior.”

¹⁰ Panel on UN Peace Operations (the “Brahimi Report”), August 2000, pp. i-xv.

- “The Panel recommends that the Secretary-General compile, in a systematic fashion and with input from Member States, a comprehensive list of potential special representatives of the Secretary-General (SRSGs), force commanders, civilian police commissioners, their potential deputies and potential heads of other components of a mission.”
- “The first 6 to 12 weeks following a ceasefire or peace accord are often the most critical ones for establishing both a stable peace and the credibility of a new operation. Opportunities lost during that period are hard to regain.”
- “To support such rapid and effective deployment, the Panel recommends that a revolving ‘on-call list’ of about 100 experienced, well qualified military officers, carefully vetted and accepted by DPKO, be created within UNSAS.”
- “Parallel on-call lists of civilian police, international judicial experts, penal experts and human rights specialists must be available in sufficient numbers to strengthen rule of law institutions....”
- “The Secretariat should also address, on an urgent basis, the needs: to put in place a transparent and decentralized recruitment mechanism for civilian field personnel; to improve the retention of the civilian specialists that are needed in every complex peace operation; and to create standby arrangements for their rapid deployment.”
- “It recommends that responsibilities for peacekeeping budgeting and procurement be moved out of the Department of Management and placed in DPKO. The Panel proposes the creation of a new and distinct body of streamlined field procurement policies and procedures; increased delegation of procurement authority to the field; and greater flexibility for field missions in the management of their budgets.”

America’s Role in Nation-Building: From Germany to Iraq, James Dobbins, et al., RAND, 2003. This report looked at a similar set of case studies to those reviewed in our paper. The authors’ most relevant conclusions are as follows:¹¹

- “Many factors influence the ease or difficulty of nation-building: prior democratic experience, level of economic development, and national homogeneity. However, among the controllable factors, the most important determinant seems to be the level of effort—measured in time, manpower, and money.”
- “Multilateral nation-building is more complex and time consuming than undertaking unilateral efforts but is also considerably less expensive for participants.”
- “Unity of command and broad participation are compatible if the major participants share a common vision and can shape international institutions accordingly.”
- “There is no quick route to nation-building. Five years seems to be the minimum required to enforce an enduring transition to democracy.”

¹¹ James Dobbins et al., 2003 pp. xxv-xxvi.

The Reconstruction of War-Torn Economies, Technical Paper, Jonathan Haughton, Harvard Institute for International Development, for USAID, June 1998. This early paper on the topic reviewed a number of post-war reconstruction efforts, mostly in-between those reviewed in our paper (i.e., after post-WWII reconstruction but before Bosnia). Key conclusions are as follows:

- Post-conflict reconstruction governments should seek a limited role, given their limited capacities.
- Macroeconomic stability should be achieved rapidly.
- Exchange-rate distortions should be avoided.
- Emigres cannot be forced to return earlier than favorable conditions are created.
- Land reform should wait until a later stage in reconstruction.
- New bureaucracies are not needed to administer aid funds, but existing donors need to be particularly flexible.
- Any aid conditionality should be kept to a minimum.
- Governments need to take good general decisions but not artificially try to signal big reforms.

Bosnia and Herzegovina: Post-Conflict Reconstruction, Country Case Study Series, World Bank, 2000. The World Bank has evaluated its experiences with post-conflict reconstruction, particularly focusing on the issues of donor coordination. The World Bank has been in the business of assisting reconstruction for a long time -- from its very beginning. Right after its 1946 creation, the first loan the World Bank made was to France to help rebuild the country after the destruction of World War II. Since the 1990s, when the world saw a substantial increase in the number of civil conflicts, World Bank funding for post-conflict assistance has escalated significantly. Assistance was given in Africa (particularly Uganda), Latin America, the Middle East, and, more recently, Europe.¹²

A series of internal reviews at the World Bank several years ago by the Operations Evaluation Department yielded important conclusions about World Bank post-conflict reconstruction.¹³ Efforts to support macroeconomic stabilization were deemed to have been highly successful, and were urged to continue as a main World Bank focus. Evaluators noted: "moving to macroeconomic stability as soon as possible in a post-conflict setting is crucial to economic recovery." Bank efficacy in supporting tax, other fiscal, and structural reforms, for instance privatization, was judged to have been of mixed success. They were urged to be undertaken incrementally. Traditional Bank work in rebuilding physical infrastructure was viewed as generally successful. Assistance aimed at developing specific key sectors often was viewed as only partially successful, often because of bureaucracies or policy obstacles that impeded development. In the area of demining, important for post-conflict societies, evaluators urged assistance in peripheral areas such as information and public awareness, but not directly in supporting physical demining. Evaluators noted the importance of investing in human capital, particularly in education and health, in a post-conflict environment. They noted that

¹² Bosnia and Herzegovina: Post-Conflict Reconstruction, World Bank, 2000, p. vii.

¹³ Ibid., p.3-9.

World Bank assistance often does not initially focus on these areas, but that nonetheless they should be considered important for early assistance given their immediate need. The World Bank also identified as important assisting institutions of governments and civil society, including public administration, transparency, accountability, the rule of law, and professions, but it noted only partial success in assisting these areas in the past. Issues related to the role of women, demobilizing ex-combatants, and cultural capital were also identified as important.

Lessons regarding Bank preparation and coordination of post-conflict assistance also were drawn. The Bank viewed its consultative group meetings, involving all relevant donors, as generally successful. Evaluators viewed these as "particularly effective for mobilizing aid resources, including facilitating the clearing of arrears..., seeking a coordinated approach to macroeconomic issues, and providing information on needs and assistance flows." World Bank coordination was seen as most effective when there was a clear international mandate for such a role, or where the local government explicitly requested such a role. It was also viewed as essential to begin donor coordination early, even before peace accords are signed. Constructive contributions were also seen when the Bank was able to organize joint needs assessments, joint financing for balance of payments and budget support, sectoral reform coordination, and collaboration with NGOs.¹⁴

While many of the above evaluations touch on some similar themes as our paper, we believe our analysis sheds new light on the importance of economic governance and what it means in a post-conflict environment.

¹⁴ Bosnia and Herzegovina: Post-Conflict Reconstruction, World Bank, 2000, p.3-9.

VI. LESSONS 1-13: GENERAL LESSONS IN ECONOMIC GOVERNANCE

Preparedness and planning beforehand

Lesson 1: Preparing for the post-conflict period should begin early, while the conflict is still under way, and include the participation of various likely donors, as well as representatives of any national organizations likely to play a role in the post-conflict government. Organizing donors, preparing to move funds, identifying key issues and counterparts, and getting personnel ready to relocate are all significant steps, requiring at least several months even with concerted effort. Only if a coordinated reconstruction effort begins preparation early, while a conflict is winding down, will all of the pieces fall into place on time.

While the Marshall Plan and Japanese Reconstruction were resounding successes, they were not so immediately. In both cases, some planning took place while the War was coming to an end. Nonetheless, the first year of reconstruction was largely seen as a time of trial and error, only after which well-planned efforts got underway.

In Bosnia, some planning was done within individual donors but not well coordinated across donors, so the reconstruction effort unfolded on an *ad hoc* basis. USAID had developed a coherent plan of programs for Bosnia, but this plan only partially was followed.

In East Timor, the extent of preparedness and planning ahead of time slightly improved, having benefited from the lessons of Bosnia and Kosovo. A Joint Assessment Mission, comprised of representatives of the UN and the World Bank, planned the reconstruction effort towards the end of the conflict, with the participation of a number of East Timorese nationals living in exile. Nonetheless, the international community was unprepared for the level of destruction that followed the independence referendum, so the full extent of in-country donor presence was less than what was required. In Iraq, criticism was made that there was insufficient planning for the post-conflict period (or, that there was planning, but it was not utilized by those who set up the immediate reconstruction effort). In Iraq, there also was widespread post-conflict destruction and looting, which was not captured or anticipated in the planning.

Rational structuring of government and donor assistance

Lesson 2: New, post-conflict governments and donor presence should be well integrated and structured to address their tasks, rather than merely reflecting underlying political tensions and donor cultures. The decision-making structures of Allied forces, under American authority, both in the Marshall Plan and Japanese Reconstruction, created effective institutions for governing after World War II. Both in Europe under the Marshall Plan and in Japan, recurrent and capital expenditures were unified under one U.S. spending authority. And donor decision-making essentially was

unified under one structure, led by the U.S., with little more than opportunities for consultations given to other donors.

In the case of the Marshall Plan, this integrated organizational approach was not designed at the outset, but rather evolved over the early years through a period of trial-and-error. After an initial disorganized piecemeal approach, U.S. efforts to reconstruct Europe and Asia were reorganized into a centralized State-War-Navy Coordination Committee (SWNCC) and a Committee on the Extension of Aid to Foreign Governments. Supporting these entities were secretariats that provided unified staff assistance to the reconstruction efforts, as opposed to a less-organized situation where staff from various agencies may coordinate policies poorly with each other. These new inter-agency institutions greatly improved management of the reconstruction effort, reducing the inter-agency bickering between Departments of War and State that took place during the first year of post-War reconstruction. Similarly in Japan, governance was streamlined and unified. General MacArthur served as Supreme Commander in Japan, reporting to the SWNCC. In Washington, a position was created for an Assistant Secretary of State for Occupied Areas.

The organization of reconstruction in Bosnia was less successful. The government itself was broken into cantons split on ethnic lines. This cumbersome form of government, while perhaps unavoidable given political tensions, has been largely ineffectual and has been an impediment to most development efforts over a number of years. And donor participation unfolded in a largely *ad hoc* manner. (In Bosnia, the Dayton Accord set this cantonal structure of government, as part of the overall set of compromises that stopped the fighting. Even in retrospect, while observers generally agree this was not an efficient way to govern the country, it is not clear whether any other arrangements would have been politically feasible at the time.)

In Kosovo, government was more unified, and the donor presence was all organized under one roof of the UN Mission. Nonetheless, each major donor had its own “pillar”. The UNHCR Pillar I focused on humanitarian assistance and resettlement immediately following the conflict. The UN Pillar II focused on civil affairs. The OSCE Pillar III focused on democratic development. The EU (and USAID) Pillar IV focused on economic development. Each pillar maintains the culture of its donor organization. Here, not only is there a problem in lack of compatibility in cultures, but there also is a problem in the cultures themselves. The UN, for instance, has taken on the role of basic governance, and yet the organization does not have many people on staff who actually have experience in governing countries, meaning that many positions were staffed by UN bureaucrats poorly skilled for their jobs. Moreover, the subsequent development in Kosovo of local institutions has created two parallel, competing governments – the UN Mission and the Provisional Institutions of Self-Government (PISG). The UN Mission is staffed with internationals, and the PISG is staffed with Kosovars who are elected or appointed by the Assembly. An attempt has been made to clarify which powers are “reserved” to the UN and which are “transferred” to PISG, but in practice in many areas the two bureaucracies are in competition.

In East Timor, the UN Mission was better integrated into one organization, and more thought was given to creating an East Timorese government. Donor funding for capital projects all was channeled through one account. Similarly in Afghanistan, a legitimate government was quickly established, and donors coordinated aid and capital investments through one account and one donor coordinating committee.

In the Iraq early reconstruction coordination has been perceived as weak between the staffs of the Defense Department, NSC, State Department, USAID, USDA, Commerce Department, and Treasury Department—all of which have participated significantly in the effort under the leadership of the CPA. Also, unlike post World War II in both Germany and Japan, when State set policy and War implemented it under the general support and supervision of the State-War-Navy Coordination Committee, in Iraq the Department of Defense in the early months set much of the policy, while, arguably, the reconstruction policy experts were located at State and USAID. Donor presence was coordinated through one institution—the Coalition Provisional Authority. Links and coordination between the CPA and Iraqi officials or counterparts have been weak at times, and there have been tensions between US government agencies involved in the reconstruction.

A number of instruments of *donor coordination* have been used, with varying degrees of usefulness. These instruments are often hard to assess, partially because reports and other documentation generated do not always accurately reflect the extent to which these efforts are successful or influential. Some include the following:

- **Joint assessments.** Multi-donor joint assessments at the outset of reconstruction activities have been instituted in recent efforts to provide better donor orientation around key priorities. These have generally been judged successful in Afghanistan and even more so in East Timor. In Iraq, the assessment exercise seemed successful, but perhaps was not particularly influential since so few donors other than the US put forward significant levels of resources.
- **Pledging conferences.** Each recent reconstruction effort involved pledging conferences. These conferences are particularly hard to assess since they always generate considerable positive reports that may not accurately reflect what donors have done.
- **Trust funds.** Trust funds managed by the World Bank were not set up in Kosovo or Bosnia—an experience that led some to urge their creation in subsequent efforts, claiming that their absence contributed to poor donor coordination. The funds in Afghanistan and East Timor have a generally good reputation. In Iraq, little money was put into the Trust Fund, making it less significant compared to the U.S. bilateral assistance effort.
- **Other donor coordination mechanisms.** Sometimes various committees of key donors have been created, with varying degrees of secretariat support, committee activity, and influence, some based in an overseas location like Washington and others in the host-country capital. Some donor coordination efforts have focused on dividing assistance responsibility by sector, while other efforts have attempted coordination of projects with donors working within the same sectors. No approach seems clearly better than others.

Focus on private-sector-led growth

Lesson 3: Even at the initial reconstruction stage, growth and job creation should be expected to come from private-sector-led growth, not government/donor spending. Creating conditions for private-sector-led growth cuts across all other lessons discussed in this paper. In a number of cases, donors have considered proposals for job creation not based on private-sector growth but rather based on direct government subsidization of job creation—such as government-funded jobs programs. Such experiences generally have not been particularly successful, only leading to fiscal imbalances and unlikely fiscal sustainability in the longer run, as well as distortions in labor markets

In smaller post-conflict countries, the donors themselves can have a negative impact on private-sector job creation as their own organizations begin to dominate the labor market for professionally skilled workers. In such cases, the better, most mobile workers wind up working for donor agencies rather than for productive enterprises; private firms find it difficult to find affordable labor; and wages are driven higher throughout the economy than labor productivity would merit, reducing competitiveness. Kosovo, Bosnia and East Timor experienced this phenomenon, which is a type of “Dutch disease.” Even large countries with small cadres of skilled professionals in the capital, such as Afghanistan, have this problem. In some cases, people trained in international organizations might go on to leading positions in the private sector, but in other cases they might just leave the country, exacerbating brain drain.

There are no shortcuts to job creation other than creating favorable conditions for a private sector to grow, particularly with low taxes and social contributions on labor. Also, removal of administrative and other barriers to small enterprise creation can be important in facilitating rapid growth of a labor-intensive SME sector.

Privatization, discussed more below in the Lesson on sequencing, may or may not be appropriate at the early stages of reconstruction. On the one hand, obviously, well-managed private firms with strong systems of corporate governance will function more efficiently than poorly run state-owned firms, better creating jobs and serving consumers. However, a successful privatization effort requires considerable resources and also a larger environment of sound overall economic conditions. Such resources and conditions may not exist immediately following a conflict situation. Consequently, the best strategy may be to postpone extensive privatization activity to a somewhat later stage of reconstruction.

Private sector development in Iraq has been hampered not only by the security situation, but also by the continuing Oil-for-Food (OFF) programs, which distributed subsidized imports to domestic consumers and reduced incentives to domestic producers and, consequently, had a negative impact on private-sector employment. Restarting Iraq’s oil sector and the commensurate inflows of foreign exchange may further harm domestic job

creation if balance-of-payments flows excessively appreciate the exchange rate and make Iraqi labor less competitive internationally.

Security and crime issues

Lesson 4: Security is essential for reconstruction and for economic development.

Economic growth requires security. Without security, either economic activity cannot take place at all, or the added costs of security to private firms and individuals increase their costs, reduce their profitability, and reduce their competitiveness. Security is a public good that the government (with international support) mostly needs to provide. Without security at present *and expectations of future security*, investors are unwilling to invest.

Allied forces in Germany and Japan were quite successful in establishing security throughout their regions of occupation. The German and the Japanese peoples accepted defeat and did not challenge the decisions taken by their leaders. These conditions were important for the subsequent sustained rapid economic growth that took place.

Bosnia, Kosovo, and East Timor have seen relatively secure conditions, with some exceptions (such as most recently in Kosovo). However, in the Balkans, this security has only come with partition of people into mostly ethnically separate areas, as well as continued significant international presence dedicated to maintaining the security. It is not clear how sustainable this presence will be, meaning that expectations regarding future security are unclear. In Afghanistan, and particularly in Iraq, the lack of security continues to be a central impediment to growth.

Security and economic growth, however, are mutually reinforcing. Only with economic development will come new job expansion, creating opportunities for the population other than in violence and thuggery. So it is wrong to think that security must precede economic development—both must come together, iteratively, and lack of progress with one will hinder the other.

Lesson 5: Post-conflict reconstruction efforts need to prevent organized (and unorganized) crime from monopolizing economic sectors and from creating a lawless environment that threatens legitimate business. Authoritarianism and common criminality often go hand-in-hand, as each develops in conditions of lawlessness. Consequently, when authoritarian regimes are dismantled immediately following a conflict, corrupt elements of the old regime often morph into criminal groups that seek to maintain control over various economic sectors in a new environment. In cases where countries previously had been under sanctions, criminal groups have often emerged that earlier had thrived on evading the sanctions. Post-conflict programs therefore need to spend considerable efforts on fighting organized crime, which otherwise can corrupt the democratization process or, at a minimum, greatly impair the general environment for domestic businesses and foreign investors.

In the Balkans, a number of organized crime groups associated with the Milosevic regime had been involved in smuggling rings in the years before the conflicts—circumventing sanctions and also facilitating transport of smuggled goods (particularly cigarettes) into Europe without paying taxes. Since the conflicts ended, many of these groups have continued to operate, expanding into new areas such as human trafficking. In Serbia, these groups killed the reformist prime minister. In other parts of former Yugoslavia, their activities raise funds for radical groups opposed to the peace process. In Afghanistan, opium production seems to have risen since the conflict ended. In contrast, in Iraq, despite setbacks in many other areas, corruption in the sale of oil revenues has largely been abated—as would be expected in moving from a state-controlled administrative system (under the UN-run Oil-For-Food program) to a market based system of sales.

Where sanctions or other restrictions on market activity have created opportunities for criminality, post-conflict economic reforms need to focus on restoring market conditions so that legitimate business can function, and a vigorous policing effort is needed to fight those organizations that have already developed. Otherwise, such criminal activities impede development of basic institutions of good governance.

The economic reform agenda predating the conflict

Lesson 6: The economic reform agenda predating the conflict needs to be addressed early in the reconstruction effort, or underlying issues that contributed to the conflict situation will continue to fester. The underlying economic relations that contribute to conflict do not disappear when peace is established. On the contrary, unless these underlying economic problems are addressed, they can continue to cause political instability even after peace is re-established. Japan had powerful *zaibatsu*, which concentrated industrial assets in the hands of militarists, in an otherwise feudal agrarian society. Bosnia, Kosovo, and Iraq were decrepit socialist economies before their conflicts, with little prospects for economic growth. East Timor had a bloated civil service that was not fiscally sustainable. Sierra Leone's illicit diamond trade provided resources for instigators of the conflict. Iraq's Oil-for-Food programs placed subsidized imports on the domestic economy and reduced incentives to domestic production. These pre-existing impediments to growth need to be addressed quickly during reconstruction in order to establish conditions for growth and job creation and to eliminate the institutions that gave instigators of conflict their economic power base. Reconstruction efforts in these countries had mixed success in addressing these issues.

Occupiers in Japan succeeded in breaking up the *zaibatsu*, introducing modern commercial laws, and fundamentally revamping the education system, thereby putting Japan on the path to market development. Kosovo received a completely new, market-oriented legal system, with foreign assistance; Bosnia only partially moved from socialist to market-oriented laws; and Iraq only has taken some first steps. In Kosovo, because the laws mostly were imposed by foreigners and because Kosovo government officials lack

strong education in market economics, it is unclear how the generally positive legal environment will fare after an eventual transfer of power to Kosovars.

In East Timor, the public administration was downsized at the outset of reconstruction efforts. Since many Indonesian civil service employees had fled at the onset of violence, this significant reduction in the civil service was achieved by eliminating positions and by hiring new East Timorese into a greatly reduced number of civil service positions. Hence there was no need to fire people from positions and the hiring process was started almost from scratch. This significant reduction in the size of the civil service reduced the total level of needed expenditures without unduly affecting the quality of government services, thereby facilitating a long-term fiscal envelope more compatible with a market economy.

In Sierra Leone, initial efforts yielded some success in bringing the diamond trade within state control. More and more diamond traders are being formally licensed by the government and their activities monitored. These efforts have increased the extent to which the state budget is benefiting from diamond revenues and has reduced the extent to which diamond revenues are being used to fund arms purchases.

In contrast to these successes, early-on no significant reforms were achieved in Iraq's Oil-for-Food programs in terms of converting them from in-kind, distortionary subsidies to monetized subsidies. As a consequence, subsidized imports distorted the economy, reducing domestic production and impeding job creation. Economic problems likely exacerbate the political situation.

Resolution of final political status

Lesson 7: Lack of resolution of final political status impedes reconstruction and economic growth. This is particularly relevant for investors. Without resolution of final political status, investors are uncertain whether their investments made today will be safeguarded in the future, and whether the agreements they make today, for instance in privatization purchases, will be respected by future governments. Lack of resolution of final political status creates uncertainty, and uncertainty impedes economic growth.

In Kosovo, the status of Kosovo as still part of a sovereign Serbia and Montenegro, but under an indefinite UN interim protectorate, has created great uncertainty regarding what final status might be expected. Similarly in Iraq, where the U.S. presence was “provisional”, lack of clarity of decision-making authority for the long-term has been an impediment to development. In both cases, political factors intervened. In Kosovo there is no broad political consensus on a final status direction—either toward independence or toward reintegration with Serbia and Montenegro. And in Iraq, there was no sufficiently competent government-in-exile to assume reins at the end of the conflict, so a provisional solution also was unavoidable. Nonetheless, to the extent possible, assistance efforts need to recognize the importance of building certainty into reconstruction processes.

Programs for key political and social constituencies

Lesson 8: Early programs in reconstruction need to focus on key political and social constituencies—including social programs to help most vulnerable population groups, benefits for veterans and decommissioned soldiers to give them a stake in the new society. For instance, Kosovo has created social programs that give needs-based assistance to the very poorest, as well as a veterans benefit to those who fought in the conflict. The latter has been a useful mechanism for quelling opposition to the post-conflict regime and reducing disenchantment with a politically important constituency. The pension program in Kosovo also partially has been used to give a politically influential group in society a benefit from the current post-conflict system. In Sierra Leone, significant effort has gone into trying to reintegrate soldiers back into civilian life. In Iraq, however, the extreme process of de-Baathification has left many influential segments without a clear stake. This has led to a more moderate stance toward the end of CPA rule.

Capacity building

Lesson 9: Building new institutions for economic governance takes time and should begin early in the reconstruction process. In some cases, government officials in central banks and ministries of finance have high education levels but not in modern economics. In other instances, the personnel of the old regimes have disappeared or are excluded from participating in new governments for political reasons, in which case staffs must be trained from scratch. In Kosovo, previous government positions had been staffed by Serbs and post-conflict positions were mostly staffed with Albanians with no government experience. In East Timor, similarly, Indonesian civil service staff left immediately at the end of the conflict, leaving donors to create a government from scratch. In Afghanistan, most ministries at very top levels have been staffed by Afghans with good education abroad (though not necessarily in the areas related to their ministerial portfolios) who have returned to the country, while lower levels in the ministries have continued to be staffed by personnel with low education levels. In Iraq, ministry staff education levels have been relatively high, though not in market economics. To greater or lesser degrees, organizing ministries, central banks, and statistical offices has taken far greater time and resources than expected ahead of time.

A key decision is the extent to which civil servants should be maintained from the old regime. On the one hand, such individuals have the knowledge and professional skills to run their agencies. On the other hand, they obviously also are linked to the pre-conflict repressive regime. In most post-conflict situations other than those where the old civil servants have fled (like in Kosovo and East Timor), lower and mid-level officials are usually kept in place, and high-level officials are ousted.

In almost all reconstruction efforts, the task of creating new institutions has turned out to be harder and more time-consuming than expected. Often, resources have been allocated

principally to day-to-day administration by internationals and insufficiently to building capacity of national policymakers. Related to this, or perhaps another way of putting it, is that too much emphasis has been put on emergency needs and not enough time on long-term development and basic governance. This has been true in Kosovo, East Timor, and Iraq.

Lesson 10: Training and educating individuals for economic governance also takes time and should begin early in the reconstruction process. Training in rote tasks, such as processing business licenses or managing a treasury system, can be taught through on-the-job training. However, educating a professional class of analysts and policymakers requires multi-year graduate education programs, either in-country in newly redesigned local graduate education programs or abroad. In Kosovo, training officials in the treasury, tax administration, and various regulatory agencies has gone fairly well. However, creating macroeconomic and fiscal analysts within the ministry of finance or the central bank (the Bank of Payments of Kosovo) has gone far less well—Kosovo simply lacks individuals who have received the basic graduate education in economics and policy analysis necessary for such work. In Afghanistan, success has been possible with senior-level officials with education abroad, but not with more poorly educated mid-level officials.

The caliber of professionals has varied quite dramatically across post-conflict situations. In Germany, Japan, and Iraq, the general caliber of the individuals found in mid-level government positions was quite high—people had good basic education, and for the most part were returning to pre-existing positions, although severe shortages in skills existed in key areas, like macroeconomic analysis and management. (Iraq was worst off of the three countries, partially because the process of de-Baathification eliminated many—but not all—competent technocrats from government.) In the cases of Kosovo, East Timor, Afghanistan, and Sierra Leone, preparation of the individuals in mid-level government positions was quite low—general education levels were low, and in many of these cases new governments have been staffed from scratch, bringing in individuals who lacked relevant professional experience. Compared to the former group of countries, the needs not only for limited professional training but also for basic graduate-level education in the latter countries were far more vast. The limited resources allocated to such education by reconstruction efforts largely explain limited progress with development in these places, and this bodes poorly for future prospects as well.

It is interesting to note that education reform in Japan, led by the U.S., was a massive undertaking, guided by a large commission sent from the U.S. that consisted of U.S. education leaders from government and primary, secondary, and higher education institutions.

Lesson 11: A modern policymaking process needs sound economic data, which requires considerable investments by donors to develop. Both in Germany and in Japan, considerable resources were allocated for developing a statistical base on the

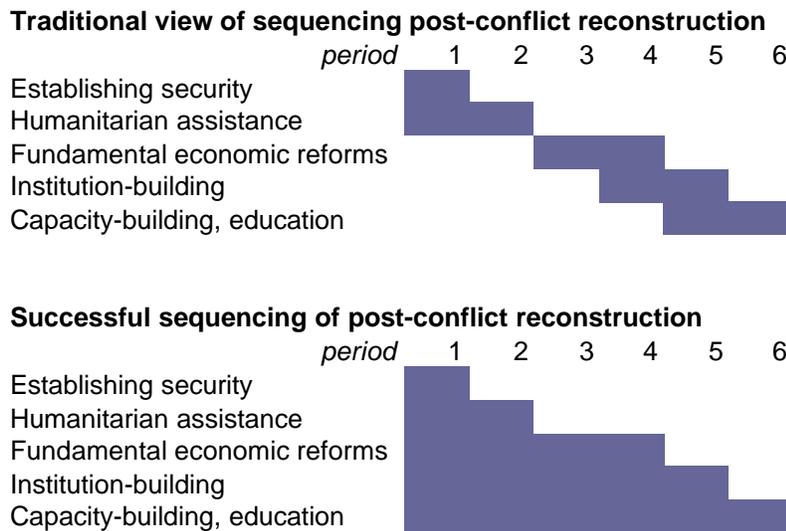
economy, and on writing analyses using these statistics. The knowledge that comes from data-based analysis was central to sound policymaking. In the more recent post-conflict reconstruction efforts, far less attention was paid to building up statistical bases, resulting in much greater difficulty in understanding what actually is happening in the economy—both for government officials and for donors. In Kosovo, the Ministry of Finance and Economy began to conduct its own ad hoc statistical analyses to construct the Consumer Price Index and national accounts because the Statistics Office was unable to produce quality statistics needed for the policymaking process. Only in late 2003 – early 2004 did donor attention really turn to the task of assisting the Statistics Office in developing all the statistics needed for a government in a modern market economy. In Afghanistan, only in 2004 was a Statistics Master Plan created to comprehensively address needs in developing statistics capacity, with agreement on allocation of assistance tasks across donors.

Sequencing

Lesson 12: High priority and time-consuming activities should be sequenced to begin towards the start of the reconstruction effort. These include security and budget execution systems and activities that are particularly time-consuming such as capacity building. The traditional view of sequencing has been to put activities such as establishing security and providing humanitarian assistance first, followed by economic reforms in a later period, with institution building and capacity building in the last stages of development. The problems with this traditional view are that, first, many economic reforms are necessary immediately to create conditions for growth and to deprive instigators of the conflict of their economic power base, and, second, activities such as institution building and capacity building take many years, so should be started earlier rather than later.

A more successful model of sequencing, therefore, would be to start a wider range of activities early in the reconstruction effort, finishing quickly short-term activities such as security and humanitarian assistance, and continuing longer-term activities such as economic reforms and institution building and capacity building for a number of years. In this way, the reconstruction effort is integrated into longer-term development.

Table VI.1



While it is clear that economic governance in general should start immediately, that is not to say that all aspects of economic governance should be done immediately. For instance, what is of note in many recent programs is the adherence to fiscal and monetary reform initially but the willingness of USAID to compromise on the implementation of privatization reforms. This flexibility is noted in several World Bank discussions on assistance in war-torn regimes¹⁵. While fiscal and monetary reform and its accompanying financial reforms are always necessary early and often, privatization needs to be considered in the context of what is being gained immediately and what is the cost to the immediate welfare of the population. Often, privatization best comes later.

In the Marshall Plan, establishment of rudimentary clearing mechanisms was sequenced first, along with restarting production and fiscal and monetary stability. Full currency convertibility and extensive financial-sector reform came later.

Lesson 13: The period at the very start of reconstruction, while difficult and often chaotic, is also an important window of opportunity to undertake politically difficult reforms and institutional changes—an opportunity that, if lost, might not reappear during the reconstruction process. Right at the start of reconstruction, the level of influence of donors is particularly high, and the level of power and organization of opponents of reform is particularly low. Donors therefore are able to undertake fundamental reforms that will not be possible at other times. During the Japanese Reconstruction, Allied occupying forces moved quickly to break up the *zaibatsu* and spread ownership more evenly across the population, and to implement sweeping education system reform. In East Timor, initial efforts focused on substantially reducing the size of the civil service to what were seen to be more appropriate long-term levels.

¹⁵ World Bank, *The World Bank's Experience with Post-Conflict Reconstruction*, OED 1998 p.34.

Such societal changes may not have been possible later in the reconstruction process. In contrast, in Iraq, many needed fundamental reforms are being put off to later stages, for instance reform of the Oil-for-Food programs to move from in-kind subsidies to monetary subsidies. Similarly in Sierra Leone, donors focused initially on a very narrow set of immediate tasks—reintegration of fighters into communities, development of local community participation in government decisionmaking, some agricultural sector and infrastructure development, and a few key changes in the diamond sector, but not broader development of economic governance capacity. The risk in such cases is that important structural reforms will be less politically feasible at a later stage.

VII. LESSONS 14 - 26: SIX PILLARS OF SOUND ECONOMIC GOVERNANCE

Macroeconomic and financial stability

Lesson 14: Prior to setting monetary and exchange policy, a post-conflict country often needs to create the instruments for setting and implementing policy: a money in circulation, a foreign-exchange market, market data on prices and exchange rates, and a policymaking process in an independent central bank (or equivalent).

Some countries continue to use their pre-conflict money; some introduce a new money; and some borrow a stable money from another country. Kosovo adopted the Deutschmark (and then the Euro). East Timor continued to use the Indonesian rupiah and then adopted the U.S. dollar. Afghanistan and Iraq continued to use their pre-conflict currencies for a short while until they introduced new currencies. Using another developed country's currency can be appealing to donors because it ensures stability and prevents the need to develop a strong commitment to stable monetary policy since responsibility for setting monetary policy is "outsourced." Also, convertibility is not an issue. But this is not always politically a viable option -- either a local population might not accept this option, or developed countries may be unwilling to lend their currencies. Physically introducing a new currency (or a borrowed currency) is an enormous logistical undertaking, requiring coordination, planning, and secure delivery of cash simultaneously around the country, supported by a massive public-relations campaign.

Implementing an exchange-rate policy requires creating a regulated foreign-exchange market where the central bank can buy and sell currency. Such a market needs transparent rules and institutions regarding auction participation and clearing. Decisions need to be made regarding who can participate in currency auctions. In Iraq for instance, a decision was made only to allow large commercial banks and not small money changers. While this decision had a political rationale, it also greatly limited the number of participants in auctions, making it easier for collusion and manipulation of market exchange rates and effectively criminalizing some segments of the foreign exchange markets

The first component in a sound monetary policymaking process is good data. Without good data, it is impossible to know what is happening with monetary aggregates, or even to know what the inflation rate is, let alone target it. In Afghanistan, for instance, during the initial post-conflict years, the central bank was unable to target inflation since there was no reliable Consumer Price Index. It was only after a rudimentary Consumer Price Index, at least for Kabul, was established that the central bank could begin targeting inflation rates rather than the exchange rate. In Kosovo, the Macro Unit of the Central Fiscal Authority (and subsequently the Ministry of Finance) developed its own CPI from scratch. It completely abandoned the data that was produced by the Statistics Office following Yugoslav statistical methodology, which was judged to be noncompliant with basic international data standards. After several interim years of producing the CPI, GDP estimates, and other data within the Ministry of Finance, the Statistics Office then again

began to develop its capacity along international standards. In post-war Germany and Japan, U.S. Occupation forces invested considerable resources in developing statistical analyses to inform policymaking.

Lesson 15: Exchange-rate and inflation policy must balance the need for stability with the need for competitiveness of exports, actively responding to neutralize the impact of large donor inflows and other post-conflict macroeconomic phenomena.

Adopting another country's currency is tantamount to a fixed exchange rate. While the central bank has no control over monetary policy in such a situation, policy makers still need to keep in mind monetary and exchange-rate issues. For instance, large inflows of capital, such as donor grants, can lead to the equivalent of an appreciation of the currency, which might make domestic labor and exports uncompetitive. This is particularly a problem in smaller countries, for instance Kosovo, where the size of donor presence relative to GDP is quite high. In such circumstances, policy makers may wish to sterilize the macroeconomic impact of donor inflows, for instance by maintaining any budget surpluses or other available funds overseas. In a country with its own new currency, for instance Iraq, a flexible exchange-rate regime usually makes most sense. A post-conflict central bank likely has depleted reserves and therefore no capacity to maintain a fixed exchange rate. Nonetheless some intervention no doubt will be necessary to counter large flows of donor and other resources into and out of the country. Kosovo, Afghanistan, East Timor, and Iraq all have more or less successfully managed open exchange rate regimes—in some cases simply by adopting another country's currency. (Bosnia, with a fixed exchange rate set by a currency board, is an exception to how monetary policy has worked in post-conflict countries. A currency board likely only would work in a relatively smaller country, where comparatively large donor inflows could be expected to prevent pressure from mounting against a fixed exchange rate.) These experiences are one example of better governance than in the period of Japanese reconstruction, when there was no freedom in current account transactions and all imports to Japan were procured by the U.S. Department of Defense. In Europe after World War II, establishing convertible currencies between European countries was a central part of the Economic Recovery Act, though not immediately introduced.

Lesson 16: Inflation policies should bring inflation rates down to low, stable levels, while still allowing for adjustments in relative price levels.

In many post-conflict countries, inflation policy is seeking to bring inflation rates down from hyperinflationary levels to a level conducive to economic growth over a very short time. A number of post-conflict countries have been quite successful. In this process, it is important to not overshoot. Most post-conflict countries also are undergoing considerable structural reforms, requiring numerous adjustments in relative prices. Because nominal prices exhibit downward stickiness, at least a low level of inflation is important for easing these relative price adjustments. Post-conflict countries probably should aim for inflation rates not higher than 10% and not lower than 5%.

The benefit of using a foreign country's currency is that hyperinflation, which might have plagued the pre-conflict economy, can be avoided. However, a country does give up its capacity to manage its own price policy. Particularly, if a country needs to undergo significant structural reforms and adjustments in relative prices, a slightly higher inflation rate than found in the Eurozone or the dollar, might be desirable, since too low an inflation rate impedes relative price adjustment given that nominal prices exhibit "downward stickiness." ("Downward stickiness" means that there is usually resistance in an economy to allowing nominal prices to fall, often due to contract commitments, accounting conventions, or psychological factors.) As a result, substantial re-adjustments in relative prices can happen more quickly in the context of a more rapid increase in overall price levels than when overall prices are rising less rapidly. A number of post-conflict countries that have adopted foreign currencies, particularly the Balkans, have succeeded in eliminating hyperinflation with one fell swoop, but nonetheless have wound up with inflation rates of 1-3% (or even deflation) when probably they would have adjusted relatively more quickly with inflation rates in the range of 5-10%.

Lesson 17: In financial sectors, policies should focus on the basics of creating a payments system and of establishing a rudimentary regulatory regime over a private banking industry, while leaving the cultivation of more sophisticated financial market institutions to a later stage in development. A rudimentary banking system that provides payment services and mediates between savers and investors is critical for an economy's functioning. Rules must insure transparency and bad loan provisioning, and also prevent government direction of lending. Other financial market institutions largely can wait until later stages of development. Where such sophisticated financial institutions might be needed, foreign institutions (or foreign experts) can be invited to play a role. For instance, Kosovo succeeded in establishing the Kosovo Pension Savings Trust, a modern funded pensions institution, with the help of foreign experts who serve on the governing board and make investment decisions.

Kosovo also was successful in quickly creating a modern banking sector. Six banks, two with significant foreign ownership, operate in Kosovo with licensing that ensures high standards, supported by a modern electronic payments clearing system.

In Iraq, also much attention was put in improving bank capacity. Progress was slow, hampered by difficult starting conditions in that most banks did not even communicate electronically with their own branches at the beginning of the reconstruction efforts.

Balanced and efficient fiscal policy

Lesson 18: Creating or improving systems of budget execution is the first priority for expenditure policy, even before developing a budget preparation process. One of the most immediate tasks a post-conflict country faces is to create mechanisms for budget execution. A government (or donor surrogate) needs a modern treasury system and expenditure information management system through which all expenditures can be implemented and monitored. In Bosnia, this was done poorly, on an *ad hoc* basis. In

Kosovo, improvements were made, and a unified treasury system implemented. (Kosovo, however, suffers from a bifurcated fiscal system, with continual competition for scarce resources between the United Nations Mission in Kosovo and the Kosovar Provisional Institutions of Self-Government, which, given recurrent surpluses, leads to excessive expenditures on low-priority areas rather than government saving.) East Timor's budget execution system is an improved iteration of Kosovo's system. And Afghanistan's system is an evolution of East Timor's system. In some sense, the system in Iraq is a step backwards, as expenditures of the government of Iraq, the Coalition Provisional Authority, and the Oil-for-Food programs have not been fully integrated into a unified expenditure system.

In Europe under the Marshall Plan and in Japan, significant attention was given to budget execution, establishing a functioning fiscal authority in those cases where the old system had been destroyed (i.e., in Germany). The fiscally disciplined Erhard Plan in Germany is credited with establishing fiscal stability and, consequently, monetary stability that laid the foundation for post-war rapid growth and development.

Lesson 19: Tax policy should evolve along with the capacity of tax administration, starting with simple indirect taxes like presumptive taxes, and developing toward more complex indirect taxes like the value-added tax. Indirect taxes, on consumption, are better than direct taxes, such as profits and income taxes, which cause more distortions. In particular, taxes and social contributions on labor should be avoided as employment generation is always a principal concern, and such taxes reduce employment by increasing labor costs. As an example, the pre-existing tax regime in former Yugoslavia, with high personal income taxes and social contributions, had been a main cause of unemployment, labor-market inefficiency, and tax evasion. One key to jumpstarting employment generation in the Balkans was to create a new tax regime that was not so highly concentrated on labor-based taxes. Bosnia was less successful with tax reform, mostly continuing the inappropriate taxes from the Yugoslav era. Kosovo was much more successful in making a clean break, introducing a new modern tax system, starting with simple presumptive taxes on total revenues, and subsequently moving to a VAT and low excise taxes. Taxes in Kosovo on labor have been kept low, initially with a ten percent personal income tax rate and no contributions to social programs other than a small contribution made to funded individual retirement accounts. Iraq, too, had had a history of relatively high labor-based taxes and ineffective indirect taxes, like the Balkans, coming out of a socialist past.

Also in Germany and in Japan, attention was paid to establishing a rational tax system, and ensuring fiscal discipline within available tax revenues so as to not cause macro instability.

Lesson 20: Capital expenditures and investment projects should be integrated into a comprehensive state public investment program and capital budget. In Bosnia and Kosovo, there was very little coordination between donors on capital expenditures and

investment projects. In East Timor and Afghanistan, progress was made in centralizing most capital expenditures through one account overseen by the World Bank. In Europe under the Marshall Plan and also in Japan, fiscal expenditures for capital projects largely were unified under U.S. authority, providing one integrated decision-making process. In Europe, only 5% of U.S. assistance was reserved for US spending needs. 95% of assistance was used for purposes proposed by European governments and agreed with the U.S..

Open trade relations

Lesson 21: Institutions need to be built to address each country's specific trade issues, creating foreign demand for domestic production. As is the case for all developing countries, foreign demand for domestic production can be the spark that ignites development. Open trade relations can provide the initial demand to start a virtuous circle of economic activity that pulls a post-conflict country out of economic collapse. However, post-conflict countries can face particular challenges, especially if a post-conflict area is not even a sovereign country and therefore has unclear rights to participate in trade negotiations, and given that post-conflict countries have a particularly difficult time in developing trade negotiating capacity. Such countries often face continued hostility from neighbors due to past ethnic and political conflicts, which severely dampens enthusiasm for trade. In Kosovo, for instance, considerable trade barriers existed because neighboring countries did not recognize Kosovo license plates, Kosovo car insurance, or any Kosovo rules of origin. And no authority consistently and adequately represented Kosovo within the southeast European regional Stability Pact. Failure to develop better trade relations in Kosovo, largely due to lack of capacity within the UN Mission (or perhaps lack of recognition of the importance of trade issues), significantly hampered prospects for Kosovo's economic development. In East Timor, on the contrary, trade relations with the rest of Indonesia were established aimed at starting economic growth.

And, of course, the success of the Marshall Plan was built on the principle of encouraging trade among post-conflict European countries, and with the US. With the autarkic experiences of the Smoot-Hawley era in mind, post-World War II policymakers were particularly keen to ensure openness of European borders and to build institutions necessary for promoting European regional trade and integration. The UN Emergency Committee for Europe, the UN European Coal Organization, and the European Central Inland Transport Organization, and then later the UN Economic Commission for Europe, all were designed to build intra-European trade links. These efforts to promote development in war-torn economies through trade integration, which subsequently evolved into the European Community and European Union, are the most successful example of economic development of the Twentieth Century.

Robust legal and regulatory regimes

Lesson 22: Basic commercial laws and institutions are necessary for jumpstarting private sector development and encouraging foreign direct investment. General laws and regulations are necessary allowing for registration of firms (individually owned, partnerships and corporations – both domestic and foreign). Private property needs to be protected. Contracts need to be enforced. Related to general contract law, legislation is needed for enforcing pledges and loans (eventually including mortgages). Bankruptcy law needs to govern the reorganization and liquidation of companies. Particularly in cases where ownership has been highly concentrated and/or held by the state, privatization law and competition policies are needed. Regulatory environments often need to be created or reformed for particular sectors: telecommunications, infrastructure, oil and gas, etc.

In some cases, countries can revert to pre-existing institutions, and in some cases they must create institutions anew. The reconstruction of Japan was an example where vast amounts of legislation were copied from various international best practices and adopted as Japanese law in order to give Japan a cut-and-pasted modern legal system. In Bosnia, Kosovo, and Afghanistan, progressively better organized efforts were made to draft internally consistent sets of legislation necessary for market economic activities, including company law, contract law, and laws governing other commercial relations. In some cases, inconsistencies remain to be resolved. For instance, much law adopted in Bosnia and Kosovo is based on Anglo common law models, while Yugoslavia is a civil law country. Given that Yugoslavia never got around to adopting a commercial code, the operative commercial code in these countries prior to recent adoption of post-conflict laws was that of the Austro-Hungarian Empire, which had been looked to as an authority by Yugoslavs.

Early efforts in Kosovo led to adoption of key commercial legislation, particularly in the following high-priority areas:

- Business organizations
- Contracts
- Pledges
- Foreign investment

A most basic point of such legislation is to quickly create a competition policy that ensures an open, level playing field so that all individuals and firms have opportunity to operate and compete in market conditions, quickly replacing the old regime where only the privileged few had rights to many economic activities.

A cookie-cutter approach like in Japan, where vast swathes of legislation are copied wholesale into a country, is the only way quickly to create a modern legal basis from scratch. However, there are obvious minuses to such an approach, as the new legislation will not entirely be consistent with existing laws, nor will it even be understood by legislators, courts, and other practitioners. On the other hand, carefully adopting each new law to the country's particular circumstances will be a prohibitively long process, taking many years at best. Each approach has its tradeoffs.

More broadly, the establishment of the rule of law, coupled with vigorous enforcement and actions against organized crime, is important for creating the basic conditions necessary for the efficient development of a healthy private sector.

Equitable social policy

Lesson 23: Social policy must evolve into well targeted efficient programs for those most in need, either from scratch or from pre-existing programs that were poorly targeted or based on political privilege. Social programs are how a country provides for the most vulnerable groups in the population particularly during periods of economic restructuring and adjustment. Social programs also can serve an important political purpose, providing benefits to influential stakeholders in the population. For instance, Kosovo established a social assistance program, based on objective poverty criteria that are relatively easy to measure for a government with limited administrative capacity, while at the same time also creating a benefit for war veterans that simply wasn't tended to appease a politically important social group. Bosnia has largely recreated the old Yugoslav system of social benefits, more based on previous job status than actual social need. And many of the other post-conflict countries still are in early stages of setting up social programs. In Japan and Germany, more attention was given to broad humanitarian assistance and food security than to administratively more complex social assistance programs.

Lesson 24: Countries that have a history and expectation of generous pension programs should move quickly to institute a modern pension system rather than back sliding into recreating the old pre-conflict system. Here it is useful to contrast the experiences of Bosnia and Kosovo. Bosnia has attempted to reinstitute the old fiscally unsustainable Yugoslav pension system, which suffers from chronic deficits, places a high cost on employers, and creates an onerous burden on the state budget, crowding out expenditures on other social programs. In contrast, Kosovo moved quickly to create a modern pension system. A limited Basic Pension is paid to all elderly over 65, funded from general revenues, without a tax on labor. And younger generations have begun contributing to the Kosovo Pension Savings Trust, a modern financial institution that invests contributors' pension assets in international financial markets following international best practices. Most other post-conflict countries have made little progress with pension reform.

Lesson 25: Gender and women's issues often are particularly important in post-conflict situations, not only because the welfare of women often has been particularly disregarded during conflicts. Under conflict regimes where the most brutal succeed, women tend to fare particularly poorly. In worst cases, rape has been used as a military strategy, and sex slavery has been rampant. As examples, rape committed by soldiers was common in Sierra Leone and in the Balkans. Enslavement of girls and women also was common during the conflict in Sierra Leone. Paradoxically,

the Balkans have seen a rise in trafficking in women and children since the time when the conflicts ended, in many cases “serving” the foreign soldiers who are supposed to be protecting the populations.¹⁶ In commerce, many women have had curtailed rights to own property, to own businesses, and to receive bank loans. Legal changes during the post-conflict stage can directly address these issues.

The first example of post-conflict reconstruction efforts that focused on gender issues was in Japan. There, Beate Sirota Gordon, the first American female civilian to join the Tokyo Occupation staff, wrote the article in the Japanese constitution guaranteeing women’s rights. Before World War II, women in Japan had no rights to marry or divorce by choice, no right of inheritance, no right of choice of domicile or property. The new constitution granted Japanese all such basic rights, marking a fundamental turnaround in the status of women in Japanese history.¹⁷ Subsequent post-conflict reconstruction efforts, to various degrees, also have addressed gender issues. Many revised laws have granted rights to women that were lacking before the conflict. In Kosovo, for instance, a certain percentage of places in the legislative Assembly were reserved for women.

Appropriate sectoral policies

Lesson 26: Appropriate sectoral policies should provide public goods where needed, particularly in infrastructure areas, without creating distortions, "picking winners," or helping some sectors at the expense of other sectors. Sectoral policies are an important complement to overall macro policy. However, sectoral policies should adequately address needs in key sectors, without causing distortions or favoring some sectors over others, following international best practices. “Sectoral” policies are secondary to “general” policies that affect the whole economy. The Government’s primary function is to set positive overall economic conditions and a level playing field, and to let markets work. Appropriate sectoral policies, therefore, mean addressing market failures, externalities, and the need for public institutions that are particular to various sectors, and not in creating any special privileges or advantages for some sectors over others.

A distinction can be made between those sectors that produce final goods and services, and intermediary sectors that form the infrastructure on which other sectors depend. In general, there is a much greater role for government in policies related to sectors of infrastructure and intermediary production than for sectors that produce final goods and services. Infrastructure sectors are where most public goods are, and where the need for government intervention is greatest.

¹⁶ “Protecting the human rights of women and girls trafficked for forced prostitution in Kosovo,” Amnesty International, 6 May 2004.

¹⁷ Nassrine Azinmi, Matt Fuller, Hiroko Nakayama (eds.), *Post-Conflict Reconstruction in Japan, Korea, Vietnam, Cambodia, East Timor and Afghanistan*, UNITAR Hiroshima Series in Post-Conflict Reconstruction, November 2002, pp.3-11.

One particularly important sector in many post-conflict countries is *agriculture*—often not because of this sector’s contribution to GDP but due to its importance in employing poorer, politically important elements of the population. In Japan, *land reform* was a central element of the Allied forces’ economic agenda. These reforms greatly increased ownership of land in agricultural regions by those who worked it. These reforms greatly contributed not only to Japan’s economic productivity but also to widespread political support for the results of U.S. occupation.

The results of sectoral reforms, in land and other areas, in more recent post-conflict countries has been quite mixed. Usually, such complex, politically sensitive reforms have not received sufficient attention from donors needed for making significant strides forward.

VIII. CASE STUDIES

The case studies discuss the major post-conflict reconstruction efforts referred to in the main text. Each case study addresses the areas covered by the learnt lessons of the main text. Each case study follows a generally similar structure: *Background* presents the historical context—the conflict and how it ended. This section also discusses topics related to preparedness of the international community for post-conflict assistance, and institutional organization of government and assistance efforts. *Economic governance* discusses issues related to the six pillars of good economic governance, as well as issues related to any pre-conflict reform agenda. *General issues* discusses remaining issues related to general lessons. And *Summary of lessons learned* sums up the relevant conclusions.

I. The Marshall Plan

Background

The Americans' ultimate goal behind the Marshall Plan was European economic recovery to benefit the long-term interests of the United States. The Truman Administration and Marshall's own conviction was that US economic recovery depended on open trade and increased international investment. Emerging out of the Smoot-Hawley legislative disasters, a deeply ingrained free trade ethic had taken hold. At this time of reconstruction design, American leaders saw the foundation of international order based on the principles of (classical) liberal capitalism, free trade and equal opportunity. These principles, according to Cordell Hall, were associated with democratic forms of government and maintained that autarky was associated with totalitarian governments (such as Stalinist Russia). They assumed that:

“...enemies in the market place could not be friends at the council table. The political line-up followed the economic line-up.”¹⁸

The emergence of the Cold War at Yalta had fueled the American resolve to rebuild the European economic space on “their own terms”. The agenda was very much constructed around filling the power vacuum left by the defeat of France, the collapse of Germany, and the exhaustion of Britain. Unless the US “assembled the components of a viable balance of power,” a vacuum could be created into which the Soviet Union might expand.¹⁹ Building economic and political systems strong enough to forestall the rise of Communist Parties was one of the primary tasks of the effort²⁰.

However, this was not the only factor. More significant for how we view the Marshall Plan in today's aid environment is that it was seen as an investment, not as a large humanitarian effort. While there was a humanitarian aspect to helping the “Christian people of Europe,”²¹ those who ran it and implemented it, as well as Truman, Clay, Hariman, Hoffman, and even to some degree George Kennan, approached it as an investment that required a rate of return. In so doing they created a management culture around the assistance effort that has not been matched in any post-war reconstruction effort (except Japan). Nor has there been a cheaper (*per capita*) reconstruction effort that achieved so much.

It is curious how much the original designs of the Marshall Plan foretold the future European Union that was to come much later in the century. American designs of the

¹⁸ Cordell Hull, *The Memories of Cordell Hull*, Vol. 1, 1948 p.364.

¹⁹ Michael Hogan, *The Marshall Plan*, 1987 p.27.

²⁰ Michael Leffler, “The American Conception of National Security and the Beginnings of the Cold War, 1945-1948,” *American Historical Review* April 1984 Vol. 89 pp. 346-381 cited in M. Hogan, 1987.

²¹ Correspondence between Ray Moseley and Harry Truman, November 26 - December 1, 1947, Harry S. Truman Library Independence MO, see US National Archives & Records Administration, ARC Identifier: 201510.

Marshall Plan were based on a “grand” design of integration. The US wanted to replace the old European system with a form of American federalism that would create a similar economic “space” to the US:

The strategic assumptions behind this policy held that an integrated economic order, particularly one headed by supranational institutions, would help to control German nationalism, reconcile Germany’s recovery with France’s economic and security concerns, and thus create a balance of power in the West sufficient to contain Soviet Power in the East.²²

The economic plans were based almost entirely on the Americans’ own experience at home, where a large economy developed that was unencumbered by borders and enhanced by free trade and a single currency, regulated when necessary by national institutions but largely based on free-market forces. A united states of Europe would bring similar benefits and provide the necessary backdrop to de-legitimize the emerging Communist parties and present a stark counter example to the already tired Stalinist state in the East.

As will be shown below, the reason the Marshall Plan had so much success, relative to other aid efforts since, was not because it was applied to “like-minded” Europeans. Nor was it a success as some have said because it was simply a capital market stimulus that pushed Europe over the top (implying that in today’s world as long as a war-torn area has access to capital markets they will be fine). Rather, it was a success because the effort was organized, encompassed economic policy as well as recovery from the beginning, and crucially, treated the entire venture as an investment, rather than as a recovery exercise, or the carrying out of a “moral obligation” to the war-torn states of Europe. As one commentator has properly put it: “our aid to Europe is primarily an investment operation”²³.

The early years of trial-and-error: 1945-1947

A focused approach was not adopted until late 1947. The unifying concept of building a unified Europe to help the US came about by a series of mistakes from which the US learned. In 1946, the effort was hopelessly piecemeal. While there was a real concern about Soviet aggression through-out the reconstruction era, the means to address this only galvanized after a year of mistakes in which some \$9 billion in a variety of aid programs were expended.²⁴

The situation in 1946 had gotten so bad that Truman called on former President Hoover to investigate the factors slowing the recovery in Germany. Upon completion of the

²² Michael Hogan, 1987.

²³ Howard Ellis, *The Economics of Freedom*, p. 34 cited in Harry Price, *The Marshall Plan and Its Meaning*, 1955 p. 93.

²⁴ It is important to note that the \$9 billion spent in one year (1946-1947) approximates about \$100 billion in today’s dollars at a 5% discount rate—roughly the amount spent in Iraq and Afghanistan between 2002-2003. See H. Price, *The Marshall Plan and Its Meaning*, 1955.

report in 1947, Truman had become convinced that almost any action would be an improvement on current policy.²⁵

The new approach emerged from their deepening conviction that that previous aid programs had failed and would continue to fail so long as American assistance was used in piecemeal efforts to revitalize national economies. The squabbling between the War and State departments was symptomatic of the drawbacks inherent in uncoordinated aid programs. Worse still, the piecemeal approach seemed to be perpetuating the very order that had hampered economic growth and led to German domination in the prewar period.²⁶

The new approach to coordinate the allocation of aid through a supra-national program known as the European Recovery Program (ERP) actually grew out of a renewed concern for what benefit the program would have for Americans, as well as the contribution of newly formed UN agencies specifically tasked with European recovery. The UN Emergency Committee for Europe, the UN European Coal Organization, and the UN European Central Inland Transport Organization had already had considerable success in distributing scarce commodities. Based on this, the UN formed the UN Economic and Social Council (ECOSOC). They concluded and recommended to the US Administration that long-term stabilization in Europe required coordinated economic management on a regional basis and recommended that a long-term permanent economic commission be established to replace the existing emergency organizations. Shortly thereafter in March 1947 the UN General Assembly established the Economic Commission for Europe (UNECE).

At the same time a clique of junior officers at the State Department (including Theodore Geiger, Paul Porter, Thomas Blaisdell Jr., Charles Kindleberger and Walt Rostow as well as Harold Cleveland) all saw the piecemeal approach with alarm and welcomed the UN example of the UNECE. This agenda was then more or less taken over by these individuals, who influenced Dean Acheson (Under Secretary of State) to request a report on the additional aid needs in various countries. This in turn strongly influenced those working closely with George Kennan's Policy Planning Staff, who encouraged the establishment of the special inter-agency entities, the State-War-Navy Coordinating Committee (SWNCC) and the Committee on the Extension of U.S. Aid to Foreign Governments. William Eddy, who headed SWNCC, proceeded to take the entire issue under study and extensively to review the type of aid and its delivery to Europe.

The results of the SWNCC work influenced several junior employees at State to become more aggressive, such as Paul Porter and Charles Bonsteel, who recommended to Kennan the following elements of the future European Recovery Act:

1. Promote currency convertibility
2. Encourage the immediate lowering of tariff barriers

²⁵ John Steelman, undated memorandum for the President, Truman Papers, PSF, General File: Herbert Hoover, cited in Michael Hogan, 1987 p.35.

²⁶ Michael Hogan, 1987 p.35.

3. Utilize the UNECE as an agency of joint programming
4. Encourage Soviet participation so as to lay the ground for an all European Settlement

This intellectual push from below eventually became watered down slightly in that meaningful Soviet participation was eventually rejected by Dulles, Truman and Marshall, and no significant role was foreseen for the nascent UN. But the point was made that European economic recovery could not be piecemeal, that a single economic space was an ultimate goal, and that institutions that promoted coordinated economic recovery in Europe were the only way to achieve a “proper” ally.

The immediate impact of this dialogue was General Clayton’s request to Acheson and Marshall for \$6-7 billion in new aid each year over a three-year period. As General Clayton recommended:

This amount was required to avert economic, social and political chaos in Europe, contain communism, prevent the collapse of America’s export trade, and achieve the goal of multilateralism. To revive the European productivity, moreover, Clayton thought it imperative that aid be used to reorganize an economy that had become divided into many watertight compartments. Like Kennan, he believed that any recovery plan must encourage a “European economic Federation.”²⁷

Truman appointed three teams to clearly investigate the resources available for an aid program and the impact the program would have on the American economy.

The Consequences of Good Planning and Clear Goal Setting: 1948 to 1951

Finally, in July 1947 Marshall made his speech at Harvard and articulated the European Recovery plan that was to become the Economic Cooperation Act – Title I of the Foreign Assistance Act that Congress passed in the spring of 1948, authorizing \$5 billion to support the first twelve months of the European Recovery Program (ERP). Paul Hoffman was appointed to head the ECA (at an annual salary of \$20,000, approximately \$104,000 in today’s wages).

The programs that emerged focused on economic governance and related issues.

Economic governance

A debate emerged as to the program direction between “free traders” and “planners”—a not entirely accurate naming of the groups. The free traders favored replacing the “patchwork” of non-convertible currencies and bi-lateral commercial agreements with a currency-clearing scheme and customs union in Europe. The planners favored increasing production first before any discussion on currency-clearing and customs union. To introduce currency clearing and customs mechanisms already in 1948, it was thought, would only exacerbate controversies over internal financial reforms necessary to bring

²⁷ See Clayton Memorandum, May 27, 1947, FRUS, 1947, 3:230-232 and Clayton’s Speech before the UNECE cited in Michael Hogan, 1987 pp. 41-43.

about such reforms. Rather, the planners wanted to concentrate on restoring Europe's existing industries, reducing production bottlenecks and reducing the worst restrictions on intra-European trade and payments. In a sense, the planners were exhibiting good economics since if the real sector is not fixed first then the financial sector will develop along a very thin base and, in the face of any (what would normally be a small) crisis, collapse, leaving questions of its legitimacy. Further, as we will point out later in this report, how the reconstruction program handles domestic debt (even more importantly than international debt) usually dictates the pace of financial reform since the thin banking sectors in these states usually have government debt on their balance sheets as their main asset.

The consequence of the debate was a sort of compromise, with the planners dominating. It was recognized that the payments system would have to be repaired sooner rather than later but that the more sophisticated problems of bank supervision and solvency, as well as currency convertibility, would have to be solved institutionally at the pace of each country's real sector development.

As Hogan states in the final section of his "Paths to Glory" of *The Marshall Plan*:

The former strategy seemed to require supranational controls and economic planning to achieve its goals; the latter would rely on normal market mechanisms. But both converged on the twin concepts of production and integration, and out of this would come a central component of the policy synthesis that would characterize American diplomacy in the years ahead. Although a customs union and clearing scheme would have to wait until production had revived, gains in production were to be accompanied by greater European efforts to stabilize finances and multilateralize intra-European trade.²⁸

Several interesting papers from Paul Hoffman and interviews with him in Price, *The Marshall Plan and Its Meaning*, reveal the intentions behind the new administrator's policies, largely reflecting the outcome of the planning versus free trader debates. Hoffman makes clear: "It is not to be a relief operation."²⁹ Very soon in the process Hoffman, as had been predicted by the junior State Department officials, saw that the problems of economic governance had to be addressed. It was not simply a question of operations of emergency reconstruction and food exports. Rather, as Hoffman and even Harriman saw, the emphasis soon began to fall on the analysis of economic conditions and needs, area by area, and on efforts to relate economic assistance to recovery policies in each country. As Price points out after extensive interviews with the major players:

Procurement and production, it was found, could not be isolated and dealt with apart from other basic elements in recovery. The task was not simply increasing production in France, Italy or Greece, and it became clear that the ECA staff must concern itself with the intensive study and coordination of individual country programs as well as with procurement and planning on "some large functional" basis³⁰.

²⁸ Michael Hogan, 1987 p.87.

²⁹ Harry Price, 1955 p.73.

³⁰ Harry Price, 1955 p.75.

This observation is crucial to our analysis of the Marshall Plan for lessons learned. Although analysis is sometimes overlooked today in modern aid efforts, it is as important as implementation.

General issues

A further important aspect of the organization was the reliance on local government procurement and public-private cooperation. The ECA did not engage directly in the purchase of aid supplies. Rather, procurement was handled by recipient governments and by private firms and nationals of the participating countries. This delegation of authority away from a large US or (worse) UN procurement agency had two distinct advantages: i) it meant there was no need for a large expensive procurement organization (such as had been created under Lend Lease and UNRRA Administrations), and ii) it made maximum use of private trade channels abroad as well as in the US.³¹

As can be seen from the opening paragraphs in every annual report prepared by the *Division of Statistics and Reports and Fiscal and Trade Policy Division* of the Economic Cooperation Administration:

Under the Economic Cooperation Act of 1948, and pursuant to the provision of the agreements entered into between the United States and certain European countries participating in the European Recovery Program, each participant receiving assistance in the form of grants has assumed an obligation to deposit in a Special Account amounts of its local currency commensurate with the amount of the basic dollar grants. In addition, participating countries deposit local currency in the Special Account to match the amount of drawing rights on other participating countries, which they exercise under the Agreement for Intra-European Payments and Compensation of October 16, 1948. There is no requirement for the deposit of local currency against assistance rendered in the form of loans or conditional aid.

These local currency counterpart funds are divided into two portions: not less than 5% is allocated to the uses of the United States within the country [largely for administration costs of the US run ECA], and the remaining 95% is to be utilized within the country as agreed between the government of the country and the Administrator.³²

The primary goals of the Marshall Plan then emerged within the first year and were largely stuck to until 1951. These were:

1. To increase production
2. To expand foreign trade
3. To enhance internal financial stability
4. To develop European Economic Cooperation

³¹ Ibid., p.78.

³² *Local Currency Counterpart Funds*, Division of Statistics and Reports and Fiscal and Trade Policy Division, Economic Cooperation Administration, April 30, 1949 p.1.

This is a slightly revised list from the one originally put forward by Bonsteel (see above) but preserved the essential “investment” nature of the entire program. Each of these was largely met. Production increased by 35% between 1948-51 and agricultural output outstripped 1939 by 16%. Trade with the US rose measurably and was sustainable. There was also a rapid increase in intra-European trade by some 80% between 1948 and 1952, a positive externality of the procurement system introduced by Hoffman at the ECA which even called for a customs union.³³ Inflationary pressure, budget deficits and unemployment were all reduced. As Gardner points out: “The atmosphere of macroeconomic crisis surrounding the recipient economies during 1947-48 had vanished with the expiration of the Marshall Plan funding in 1951.”³⁴ Finally a European payments system was created under the OEEC, currencies became convertible, and the phrase European Union was first used.

Some of the Numbers

The magnitude of the aid effort is important. It is also noteworthy that despite a general sense of success surrounding the Marshall Plan, there was a year of waste. One of the key measures of success, in any aid effort, is the extent to which it recovers from these initial growing pains. In this case, the President, Harry Truman, had the wherewithal to seize the program from its current course, enlist the support of his political enemies, and redirect the effort.

Table VIII.1

| Initial US AID (1946-48) and Marshall Plan AID (1948-51) (\$US billions) | | | | | | | | | |
|--|-------------------|----------------|----------|-------------------|----------|----------|-----------------------------|-------------------------|--------------------------|
| | | Initial US Aid | | Marshall Plan Aid | | | Total Pre-Marshall Plan Aid | Total Marshall Plan Aid | Total Aid Effort 1946-52 |
| | | 1946-47 | 1947-48 | 1948-49 | 1949-50 | 1950-51 | | | |
| Amount Current Dollars | | \$4.600 | \$5.800 | \$4.950 | \$3.500 | \$4.155 | \$10.400 | \$12.605 | \$23.005 |
| | Factor Adjustment | | | | | | | | |
| Adjusted by GDP growth from 1948-2004 | 16.00 | \$73.600 | \$92.800 | \$79.200 | \$56.000 | \$66.480 | \$166.400 | \$201.680 | \$368.080 |
| Adjusted by Av. CPI to 2004 | 6.65 | \$30.590 | \$38.570 | \$32.918 | \$23.275 | \$27.631 | \$69.160 | \$83.823 | \$152.983 |
| Adjusted by GDP Deflator 1948-2004 | 6.45 | \$29.670 | \$37.410 | \$31.928 | \$22.575 | \$26.800 | \$67.080 | \$81.302 | \$148.382 |
| Adjusted by Av. PCE to 2004 | 5.36 | \$24.656 | \$31.088 | \$26.532 | \$18.760 | \$22.271 | \$55.744 | \$67.563 | \$123.307 |
| Sources: | | | | | | | | | |
| Michael Hogan (1987), Harry Price (1955) Roy Gardner (1999) and Barry Eichengreen (1999), Martin Schain (1999) | | | | | | | | | |
| Paul Christopher Eclipse Capital, James Dobbins (2003) | | | | | | | | | |
| Notes: | | | | | | | | | |
| Initial US Aid in 1946-1948 is broken down as follows: | | | | | | | | | |
| 1946-47: \$3.4 billion directly from US sources + \$1.2 billion from the US to the IMF, IBRD (World Bank) and UN | | | | | | | | | |
| 1947-48: \$4.7 billion directly from US sources plus \$1.1 billion from the US to the IMF, IBRD and UN | | | | | | | | | |

The "best" factor adjustment to use is the GDP deflator since we are adjusting a large basket of goods from manufactures to commodities. It is seen here that in two packages

³³ Intra-European Trade data from Harry Price, 1955 p.125.

³⁴ Roy Gardner, “The Marshall Plan Fifty Years Later: Three What-Ifs and a When” in Martin Schain, *The Marshall Plan Fifty Years After*, 2001 p.121.

the Pre-Marshall Plan Aid was about \$67 billion in today's dollars--a larger package totaling \$87 billion passed Congress for Iraq and Afghanistan. The total Marshall Plan budget today would be \$81.3 billion. Even if we use the over estimate of CPI, with its upward bias, the package was roughly \$83.8 billion—still smaller than similar requests by the current Bush Administration of \$87 billion (for one year!). This is noteworthy since several commentators³⁵ have made the case that similar packages could not pass Congress today. Similarly, Eichengreen has noted the dissimilarities in the aid and its magnitude--this clearly is not true unless we use the GDP growth estimate--which is not realistic.

The total aid package, if we look at aid to Europe as both the initial pre-Marshall Plan years and the time after the passage of the European Recovery Program, comes to \$148 billion over six years, covering some 200 million people. Compare this with \$87 billion over one year covering roughly 45 million people, and we see the Marshall Plan effort, while successful, was also very cheap in absolute and in *per capita* terms.

Lessons Learned

A unique reconstruction program was the consequence of this effort and planning—unique in that it has not been replicated since the Occupation of Japan. Its hallmarks are important, as is their absence from later reconstruction efforts after 1960 and introduced again only slowly after 1999. The significant lessons are as follows:

- Overall authority rested with the main source of funds—the United States.
- The US admitted flat-out it was an investment program designed to make a return to the main investor--the United States.
- That overall authority was “benevolent” enough to allow 95% of the funding to be committed to projects and investments deemed important by the recipient state.
- All funds worked via existing budgeting processes in the war-torn economies, and in those countries that did not have a budget process (such as post-War Germany), one was quickly set-up, at the same time as humanitarian assistance began.
- The Erhard plan was encouraged and fostered as part of a standard institutional infrastructure program in which fiscal and monetary policy were paramount, essential and initial.
- The focus on institutional reconstruction at the fiscal authority was on budget *execution* more than on budget *preparation*. This recognized the immediacy of establishing the fiscal authority, the relative simplicity of the existing revenue base (making budget preparation a secondary priority), and the need to have a proper future tax base, so as to avoid future inflationary pressure.³⁶

³⁵ Gardner, 1999.

³⁶ It is interesting to note that the Marshall Planners had not yet heard of rational expectations or the Lucas/Sargent and Wallace critique of fiscal/monetary policy interaction—namely, that monetary policy problems usually are caused by bad fiscal policy, i.e., excessive spending that leads to printing money. It is clear from their planning however, that they understood the problem known today as the “unpleasant monetary arithmetic” and that failure to address a proper tax base would create inflationary expectations. They were no doubt familiar with the worst hyperinflation in history that took place in Weimar Germany between the Wars. Their actions would be seen today by modern macroeconomists as understanding and

- The overall authority—the US—was clear in its admission that it had an agenda beyond economic reconstruction. It was to create a clear counter-weight to Soviet Communism in Western Europe. This admission by the Truman Administration early on in the process (i.e., during the debate on the ECA in the Congress over 1947) shaped the context of the economic advice and allowed for very pragmatic discussions on what could and could not be achieved by Marshall Planners in Europe when they went to the US Congress for funds.
- All funds went via one fund’s administration. No bifurcation of multiple funding sources existed to confuse the reconstruction effort; no “pet” capital projects from various donors made to satisfy the donor contractors were permitted. This allowed a proper capital budget to be formed in conjunction with the current budget, providing for responsible fiscal policy planning.
- All participants had to contribute on their own to receive “counterpart funds” from the US.
- There was no complex legal authority assessing the “liability” of funds use (such as the UN Legal Department in New York, which second guesses policy decisions made in field operations).

The consequence was a rational, fiscally consistent, demand-driven reconstruction process influenced by only one bureaucracy rather than many. Its costs in today’s dollars were quite small given the benefits and the number of beneficiaries, and in absolute terms it is still smaller than allocations by Congress made in the last year by several billion dollars.

incorporating into their policy actions the Lucas critique that emerged from the Lucas/Sargent and Wallace debate over the 1970s.

II. The Reconstruction of Japan

Background

The basic strategic objectives of Allied interests in Japan were made clear by the Declaration presented after the Cairo Conference, December 1943, by Roosevelt, Churchill, and Chiang Kai-shek, in which the Allies expressed intent to liberate all territories seized by Japan and to fight until unconditional surrender by Japan. They also made clear they had no intentions of seeking territorial claims against Japan's pre-war boundaries. At Yalta, the Soviet Union agreed to enter the war against Japan once the Germans were defeated. In July 1945, after the Potsdam summit, a Proclamation was made outlining the surrender terms. In the Yalta and Potsdam declarations are the principles that guided US reconstruction efforts. (See box on the Potsdam Proclamation.³⁷)

Box VIII.1: Potsdam Proclamation Excerpt

(9) The Japanese military forces, after being completely disarmed, shall be permitted to return to their homes with the opportunity to lead peaceful and productive lives.

(10) We do not intend that the Japanese shall be enslaved as a race or destroyed as a nation, but stern justice shall be meted out to all war criminals, including those who have visited cruelties upon our prisoners. The Japanese Government shall remove all obstacles to the revival and strengthening of democratic tendencies among the Japanese people. Freedom of speech, of religion, and of thought, as well as respect for the fundamental human rights shall be established.

(11) Japan shall be permitted to maintain such industries as will sustain her economy and permit the exaction of just reparations in kind, but not those which would enable her to re-arm for war. To this end, access to, as distinguished from control of, raw materials shall be permitted. Eventual Japanese participation in world trade relations shall be permitted.

(12) The occupying forces of the Allies shall be withdrawn from Japan as soon as these objectives have been accomplished and there has been established in accordance with the freely expressed will of the Japanese people a peacefully inclined and responsible government.

³⁷ Potsdam Proclamation Defining Terms for Japanese Surrender, 26 July 1945, in *Occupation of Japan: Policy and Progress*, pp. 53-55.

A number of agencies were created to oversee Japanese reconstruction, as detailed in the following paragraphs. The Far Eastern Commission (FEC) was established as the senior decision-making body, based in Washington, including representatives from the major Allied countries. The US Government acted as agent for the Commission, through which all Commission decisions were passed. It was made clear that US Government decisions were ultimately binding (in case of disagreements among Allies). The Commission was not particularly active, but was nonetheless an important body for political reasons—the Soviets wanted a body that had formal decision-making authority to which they belonged. A previous proposal had been made to create a Far Eastern Advisory Commission, which would give other Allied Powers representation in an advisory role, but this was deemed as insufficient by the Soviets, who wanted decision-making authority, so the FEC was proposed instead, with at least the appearance of decision-making authority.

Within the US Government, a State-War-Navy Coordinating Committee was created to coordinate all US policy in the “occupied areas,” which included Japan, Germany, Austria, and Korea. The War Department was given clear jurisdiction for “execution and administration of policy.” State Department took the lead in setting policy toward the occupied areas, which was overseen by a newly created position of Assistant Secretary of State for Occupied Areas. A Germany-Austria Secretariat and Japan-Korea Secretariat were created, which were regularly meeting inter-agency fora for discussing policy issues in the occupied territories.³⁸

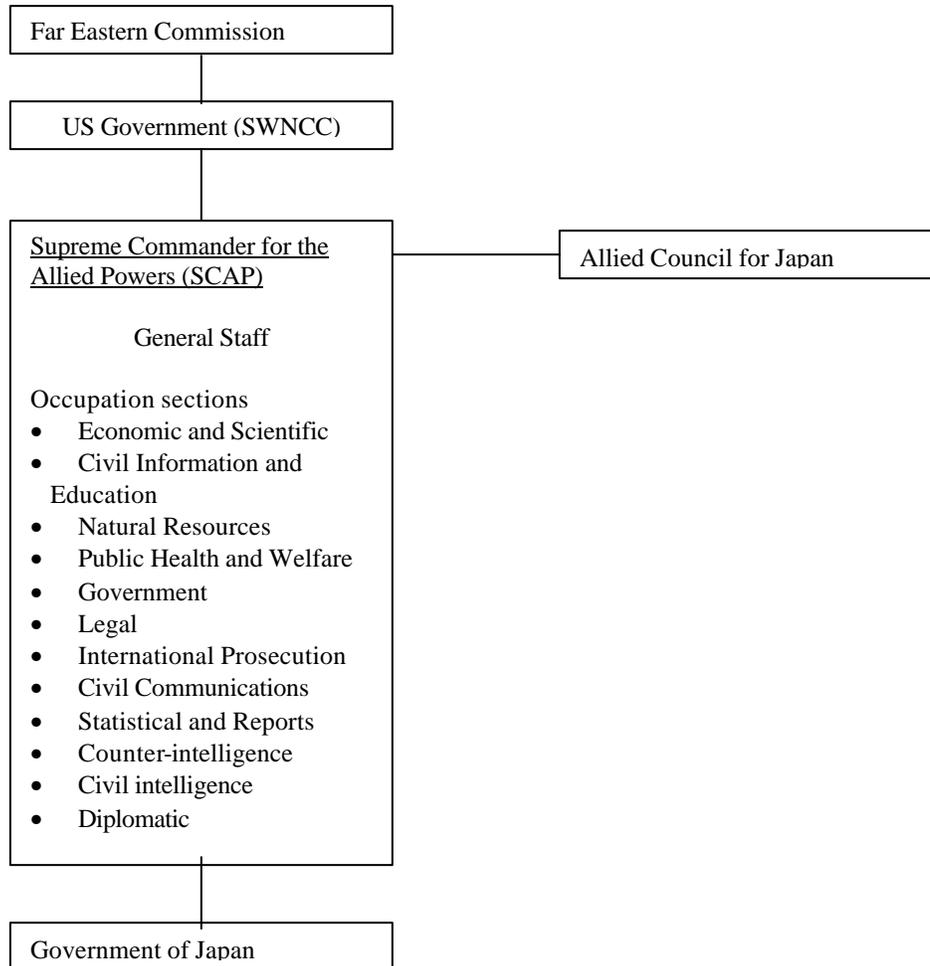
“Each Secretariat shall hold stated meetings and a record of its proceedings shall be maintained. Each Chairman shall compile a list of projects and studies in respect of occupational affairs, as suggested by the members of the Secretariat. These projects shall be assigned for study and preparation and submission to SWNC on the basis of relative urgency as determined by the Assistant Secretary for Occupied Areas.”

Underneath US Government jurisdiction was the Supreme Commander for the Allied Powers (SCAP), Douglas MacArthur. The Allied Council for Japan, based in Tokyo, advised on all policy issues. Like the Far Eastern Commission, the Allied Council contained representatives from the major Allied powers. This Council though had only an advisory role. The SCAP had his own General Staff, plus the Occupation staff had a number of sections, as presented in the below chart. Of particular note: The Economic and Scientific Section was responsible for economic and reconstruction policy; the Government Section led in liaising with the Japanese Government; and the Statistical and Reports Section generated all statistics needed to feed into the policymaking process. The Government of Japan continued to operate, purged of most militaristic elements. While the Occupation had the authority to act without going through the Government, it was intended that the Government would implement all policies to the extent possible.

³⁸ “Organization and Procedure for the Development and Promulgation of United States Policy with Respect to Occupied Areas,” in *Occupation of Japan: Policy and Progress*, 1969 pp. 82-84.

The agencies responsible for the Occupation of Japan were organized according to the following chart³⁹:

Chart VIII.1: Organizational structure of Occupation agencies



It is interesting to note how this configuration of organizational structures compares with contemporary institutions. As an overall way of providing assistance, the Japanese experience was *ad hoc*. Partially based on the experiences of the post-War period, USAID later was created as a permanent, specialized agency to manage US foreign assistance projects, rather than the *ad hoc* SWNCC. However, there also are some similarities. The inter-agency working groups set up to coordinate development and governance in Japan have some similarity to similar inter-agency groups established to manage the US presence in Iraq. The SWNCC had more of a unified structure and larger secretariat than the contemporary equivalent for Iraq, though today's institutions benefit from the considerable institutional support provided by USAID, which did not exist during the Japanese Occupation. There are many parallels between the SCAP in Japan and the Coalition Provisional Authority in Iraq.

³⁹ Occupation of Japan: Policy and Progress, 1969, pp. 7-16.

Economic governance

Initial general US policy toward Japan was set down in a document called “United States Initial Post-Surrender Policy for Japan,” prepared jointly by the Department of State, the War Department, and the Navy Department, signed by the president in September 1945 and transmitted to the SCAP. The document set key political and economic policies, including the following relevant for this analysis.⁴⁰

- In order to conserve US resources, the US mostly would act through the Japanese Government, which was intended to continue operating under the supervision of the SCAP.
- This policy of working through the Government was to “use the existing form of Government in Japan, not to support it. Changes in the form of Government initiated by the Japanese people or government in the direction of modifying its feudal and authoritarian tendencies are to be permitted and favored.”
- The Government was permitted, under SCAP supervision, to facilitate economic activity through regulation of “national public services, finance, banking, and production and distribution of essential commodities.”
- “The Japanese authorities will remain responsible for the management and direction of the domestic fiscal, monetary, and credit policies subject to the approval and review of the Supreme Commander.”
- Industry was to be demilitarized, by “conversion to other uses, transfer abroad, and scrapping.”
- Policy would “favor a program for the dissolution of the large industrial and banking combinations which have exercised control of a great part of Japan’s trade and industry.”
- “Japan shall be permitted eventually to resume normal trade relations with the rest of the world. During occupation and under suitable controls, Japan will be permitted to purchase from foreign countries raw materials and other goods that it may need for peaceful purpose, and to export goods to pay for approved imports.”

Immediate attention of the Occupation forces on economic issues, in addition to demilitarization, focused on real-sector economic activity needed to feed the population. The rice industry had been decimated by war, as well as particularly inclement weather, and the fishing fleet equally was in a state of ruin. Initial attention turned to helping these two sectors to rebuild, and to directing scarce foreign currency earned from exports to the purpose of buying food imports. While supporting rebuilding of the fishing industry, Occupation authorities nonetheless required adherence to international agreements and best practices regarding whaling and fishery conservation, that is, not only focusing on the immediate task at hand but also on the longer term.

⁴⁰Ibid., pp. 73-81.

The largest restructuring reforms focused on breaking up the *zaibatsu* (Japan's large holding companies that monopolized industry). These huge conglomerates were broken into smaller firms; ownership was dispersed across greater numbers of smaller shareholders; rules were adopted to prevent excessive cross ownership or participation by individuals on too many company boards; and firms were prevented from participating in international cartels or otherwise restrictive trade agreements. Much of this work was undertaken by a Holding Company Liquidation Commission formed by the Diet. Although concentration of industrial ownership remains a problem with the economy of Japan to this day, the Occupation reform efforts nonetheless made considerable strides (compared to the pre-war period) in liquidating a number of the most influential *zaibatsu* and reducing concentration of ownership in large firms by transforming them from being held by a few wealthy families to being publicly traded and held by employees and others.

US policy on trade was that, "[e]ventually, foreign trade with Japan will be restored to private hands, in line with accepted principles of United States commercial policy." For an interim time period, however, trade was centrally managed. Exports were managed by the United States Commercial Company, which was a subsidiary of the Reconstruction Finance Corporation. The Company had been involved in similar trade operations in Italy. The US Commerce Department represented the Commercial Company in the US to potential buyers of Japanese exports. Attention was particularly paid to possibilities for exporting silk and textiles. The War Department managed procurement and importation of goods to Japan. During this initial time, Japan essentially had no convertible exchange rate, and free private trade outside of US Government activities was all but impossible.⁴¹

General issues

The Occupation forces embarked on sweeping, though not all-encompassing, political reform. Individual rights and freedoms were established. Many organizations related to secret police and means of control of the population were disbanded. Individuals who had held high office particularly related to militarism in the past were barred from future public office. The Diet was given real legislative power. A "bill of rights", a new constitution, and elections were all organized. The Emperor disavowed divine lineage as well as the belief in the superiority of the Japanese people over other peoples. However, most notably in terms of continuity rather than reform, the Emperor's position was maintained and not abolished, albeit in a reduced role. The Emperor remained as the symbol of the Japanese people, his position enshrined in the constitution.

Part of the Occupation activities included a comprehensive review and reform of the education system, decentralizing it and ridding it of nationalism and militarism. The review and reform proposals were done by a delegation of 27 leading US education experts who spent a month examining Japan's education system. The highly centralized system was recommended to be greatly decentralized. The mission even made

⁴¹ "Interim Plans for Control and Regulation of Japanese Trade with the United States," March 1, 1946, in *Occupation of Japan: Policy and Progress*, 1969 pp. 168-171.

recommendations in great detail regarding reform of the Japanese language to make it more accessible to average people. On the issue of language reform, the mission noted that “the time for taking this momentous step is perhaps more favorable now than it will be for many years to come.” The report of the mission also noted: “In order that the newer aims of the education may be achieved, teaching methods emphasizing memorization, conformity and a vertical system of duties and loyalties should be modified to encourage independent thinking, the development of personality, and the rights and responsibilities of democratic citizenship.” The report also concluded: “Attention needs to be given to the improvement of professional education in fields such as medicine, school administration, journalism, labor relations, and public administration.”⁴² The lesson here is that architects of the Occupation did not see their job as merely maintaining the *status quo* during an interim time period but rather one of bringing about needed fundamental reforms.

The first example of post-conflict reconstruction efforts that focused on gender issues was in Japan. There, Beate Sirota Gordon, the first American female civilian to join the Tokyo Occupation staff, wrote the article in the Japanese constitution guaranteeing women’s rights. Before World War II, women in Japan had no rights to marry or divorce by choice, no right of inheritance, no right of choice of domicile or property. The new constitution granted Japanese all such basic rights, marking a fundamental turnaround in the status of women in Japanese history.⁴³

Lessons learned

The following lessons were learned from the experience of post-War reconstruction in Japan:

- Authority was unified under US Government rule, even though other nations nominally and actually played a role.
- The Japanese Government was maintained, subordinated to the Occupation. This subordination was a condition to the surrender. While a shortlist of senior ex-officials to be banned from government was prepared, there was no widespread purge of government bureaucracies, recognizing a need to maintain a competent civil service.
- The Occupation addressed key pre-war development issues facing Japan— evolution away from feudalism toward a market economy; breaking up and reforming ownership of the *zaibatsu*. Pursuing what could be called a pre-conflict economic reform agenda was clearly a goal from the outset, even in the international documents signed as the war was winding down, indicating clear

⁴² United States Education Mission to Japan, Digest of Report, April 6, 1946, in Occupation of Japan: Policy and Progress, 1969 pp. 156-163.

⁴³ Nassrine Azinmi, Matt Fuller, Hiroko Nakayama (eds.), Post-Conflict Reconstruction in Japan, Korea, Vietnam, Cambodia, East Timor and Afghanistan, UNITAR Hiroshima Series in Post-Conflict Reconstruction, 2002, pp. 3-11.

determination to address the underlying economic factors that had enabled the war in the first place.

- Major reforms, such as breaking up the *zaibatsu* and implementing sweeping education reform, were started quickly, when politically feasible to do so, rather than waiting until later, when a window of political opportunity would have closed.
- Attention was paid to statistics. Analysis and studies, based on sound data, fed into the Occupation authorities' policymaking process. A sizable US government office was created in Tokyo to generate sound statistics and analytical reports, that were intended to feed into the policymaking process.
- Attention was paid to capacity-building and education. The education system was completely overhauled, with the goals of depoliticizing and modernizing it. Resources were allocated for retraining civil servants and private-sector managers.

III. Bosnia and Herzegovina

Background

The conflict in Bosnia and Herzegovina (BiH) left the Republic devastated. 250,000 people died. A million refugees fled. And physical infrastructure was destroyed. Part of the background that is relevant is the political context -- a history of ethnic conflict between Serbs, Croats and other minorities, and between Orthodox, Catholics, and Muslims. Another important part of the background is the economic context and its relation to the political situation. Not only had Yugoslavia been an authoritarian society with repressed ethnic tensions, but it also had been a socialist country struggling to reinvigorate the economy through fundamental reforms -- privatization of state-owned enterprises, liberalization of markets, etc. In these struggles over economic reforms, ultra-nationalists most often were aligned against reform efforts and moderates in favor; Serbia felt they would lose from reforms, and others that they would gain.⁴⁴ This context and the link between the economic and political impediments to development are important in that the key to improving the political situation partially would hinge on making breakthroughs with economic reforms, and, consequently, failure to make fundamental breakthroughs with reforms would lead to sluggish progress in addressing political problems.

The Dayton accords were riddled with the political ambiguity and compromise needed for gaining widespread support. The principle of ethnic cleansing was rejected, but the reality of far greater ethnic homogeneity in communities implicitly was accepted. Partitioning of BiH formally was rejected, but such great autonomy was granted to the various ethnic areas so as to make central government ineffectual. Along with political decentralization, fiscal arrangements also were decentralized, leaving the central state weak and with few options for generating revenues.⁴⁵

The Dayton and subsequent Paris agreements organized the international presence under a Peace Implementation Council (PIC), with members from participating bilateral and multilateral entities, along with a PIC Steering Board. Supreme leadership was vested in the Office of the High Representative (OHR).⁴⁶ Sectoral committees were formed of interested donors, in each case led by whatever donor seemed to have the most relevant competence and interest. World Bank participation started early. Representatives from the World Bank attended Dayton discussions. This was quite novel at the time, for an international financial institution representative to attend a peace conference.⁴⁷ The World Bank made a relatively early commitment to be involved with Bosnia reconstruction, particularly given that Bosnia had unpaid arrears owed to the World Bank due to past lending to Yugoslavia. (The World Bank had lent considerably to Yugoslavia for a structural adjustment loan and sectoral reforms before the era of hyperinflation and political meltdown.) Initial World Bank activities were funded by Dutch grants. A report

⁴⁴ Bosnia and Herzegovina: Post-Conflict Reconstruction, World Bank, 2000, pp. 21-23.

⁴⁵ Ibid., pp. 23-26.

⁴⁶ Ibid., p. 26 .

⁴⁷ Ibid., p. 32.

was prepared jointly by the World Bank and the EC for the first donor conference on Bosnia, in December 1995. The report outlined reconstruction needs, stressing reconstruction over relief. A "two-track" assistance strategy was adopted, jumpstarting some emergency projects immediately, followed by more normal assistance programs later, after arrears to the Bank were cleared and membership achieved. A special Bank Trust Fund for BiH (TFBH) was created. Emergency projects focused on: import procurement, transport reconstruction, farm reconstruction, lottery and sanitation, heating rehabilitation, education, war victims, the mobilization and reintegration, electric power, housing, land mines clearance, public works and employment, balance of payments support, hospitals, industry, and local initiatives. These projects generally were reviewed as successful, perhaps with the exception of the budget support, which was characterized as not sufficiently transparent and with low accountability. Little attention initially was given by the World Bank to policy reform in enterprises and banking, privatization, and other market reforms.⁴⁸

Discussions led by the World Bank in 1997 led to efforts to rationalize assistance. It was suggested that future programs should focus on four priority areas: "infrastructure, refugee return and community support programs, social sectors, and employment creation through private sector and financial sector reforms with an overall emphasis on sustainability."⁴⁹

In the early years, USAID focused on emergency assistance. After the initial post-Dayton period, during the period of 1995-2003, USAID assistance expanded into some economic governance areas, including fiscal issues, the banking sector (i.e., assisting in establishing a payments system through banks rather than through NGOs), and the currency board. More recently (particularly from the start of the 2003 USAID Strategic Plan), USAID has shifted focus toward capacity building to build BiH as a viable multi-ethnic nation, including more emphasis on economic governance. Initial USAID assistance after the Dayton Agreement, in 1996, focused on: "(a) repairing war-damaged infrastructure to facilitate internally displaced person (IDP) and refugee return; (b) restoring private sector productive capacity; (c) establishing a policy and institutional framework for an emerging market economy; and (d) strengthening democratic institutions that promote a multi-ethnic society and political pluralism. Of the \$890 million USAID provided through FY 2000, approximately two-thirds was for reconstruction associated with efforts to permit citizens to return to their homes. These objectives were either substantially achieved or the framework put in place for future completion."⁵⁰

According to the Strategic Plan: "The U. S. Mission to BiH applies ten Benchmarks for measuring progress. They are used to report to Congress and others. The USAID program directly supports the first seven items listed below.

- Economic Development
- Elections and Democratic Governance

⁴⁸ Bosnia and Herzegovina: Post-Conflict Reconstruction, World Bank, 2000, pp. 29-41.

⁴⁹ Ibid., p. 44.

⁵⁰ USAID / Bosnia and Herzegovina Strategic Plan Summary, October 2003.

- Media Reform
- Displaced Person and Refugee Returns
- Brcko
- Illegal Institutions, Organized Crime and Corruption
- Judicial Reform
- Military Stability
- Public Security and Law Enforcement
- Persons Indicted for War Crimes

“USAID also directly supports key areas of the Mission Performance Plan (MPP). Specifically, USAID supports the MPP goals of Economic Development – A self-sustaining market economy within a single economic space that demonstrates growth without dependence on foreign economic assistance; Humanitarian Assistance – Conditions permit the self-sustaining voluntary return of all Bosnian displaced persons and refugees to their place of origin who wish to do so; and Democracy – State-level institutions are functioning smoothly with broad public support and dependable domestic sources of revenue, and Bosnia is a more participatory, inclusive democracy. Direct support is also given to Stability Pact objectives.”⁵¹

Economic governance

Progress with economic development has been sluggish, slowed at every step by the inability to resolve political differences. Excessive fiscal decentralization impedes formulation of a unified fiscal policy. Creation of a unified economic space is impeded by varying laws in various jurisdictions (some adopted from Serbia, some from Croatia); the use of several currencies; lack of cooperation at the technical level (for instance in rationalizing the telephone network); security issues that hinder travel; etc.⁵²

An important issue is that of the currency. While it was agreed to support a single currency for the whole space, there was disagreement initially as to whether BiH needed its own currency or whether it could simply adopt a nearby stable currency (the Deutschmark). In the end, Bosnia adopted its own currency, the Convertible Mark, fixed at first to the Deutschmark and then to the Euro, using a currency board. Bosnia’s fixed rate and currency board are an exception to how monetary policy has worked in post-conflict countries. A currency board would likely only work in a relatively smaller country, particularly where comparatively large donor inflows could be expected to prevent pressure from mounting against the fixed rate.

Social welfare programs also were implemented. Some evidence suggests that subsidies to the population could have been better needs tested. Like in the rest of Yugoslavia, the pension system and other social programs funded from wage-based contributions were in a state of crisis before the conflict. High payroll taxes drove labor into the shadow economy and increased unemployment. This resulted in reduced revenues, coupled with

⁵¹ USAID / Bosnia and Herzegovina Strategic Plan Summary, October 2003.

⁵² Bosnia and Herzegovina: Post-Conflict Reconstruction, World Bank, 2000, pp. 49-51.

excessive expenditures of an unsustainably generous pension system, led to chronic deficit and arrears. Failure to institute fundamental reforms obviously has led to a continuation of the problem—chronically unsustainable fiscal commitments in the social sector.

The pension situation is a good case in point. In 1996, 11 percent of GDP was spent on social programs. However, almost all of this (90%) was spent specifically on pensions and veterans' benefits. The large amount spent on social programs necessitated high taxes and crowded out spending on other government priorities. Within social spending, the excessive amount spent on pensions particularly meant that precious little was left over for social assistance to those most in need. As of mid-1998, three separate pension funds were operating, all on a pay-as-you-go basis, all physically unsustainable, but each with its own particular rules and formulas for benefit calculation. Given the economies of scale and administration for such pension systems, the existence of one fund for each entity meant substantial inefficiencies in the system, in addition to the broader issue of lack of fiscal sustainability. New legislation in 1998 made some improvements, for instance raising retirement ages. But fundamental fiscal problems have not yet been really addressed. The World Bank 1999 report underscores the need for fundamental reforms, including exploring possibilities for funded individual retirement accounts, but no real progress has been made in this direction.⁵³

Strategic Objective 1.3 of the new USAID Strategic Plan focuses on “accelerated development of the private sector.” The Plan notes: “The macroeconomic environment is favorable including low inflation and real GDP growth. However, external aid rather than private investment has fueled much of this economic success. Continued dependence on international donor assistance is not sustainable.” The plan proposes activities in the following areas: “(1) economic policy reform that creates an enabling environment for business and investment; (2) reform of a repressed and undercapitalized financial sector to ensure that productive projects have adequate access to financing; and (3) strengthening the capacity of the private sector, especially SMEs, to operate and compete in a market economy.”⁵⁴

General issues

Progress with growth and development was sufficiently slow that, in the study prepared for the 1999 donors conference, it was noted that considerable reform effort would be needed in order to achieve a level of development in the early 21st-century equal to two thirds the level enjoyed before the conflict. It was also noted that far greater success had been achieved with physical reconstruction (roads, houses, schools) than with building institutions and achieving policy reforms.⁵⁵

⁵³ Bosnia and Herzegovina: 1996-1998 Lessons and Accomplishments, Report for the May 1999 Donors Conference, World Bank and European Commission, 1999, Annex 14.

⁵⁴ USAID / Bosnia and Herzegovina Strategic Plan Summary, October 2003.

⁵⁵ Bosnia and Herzegovina: 1996-1998 Lessons and Accomplishments, Report for the May 1999 Donors Conference, 1999, pp. iv-v.

The most recent USAID Strategic Plan aptly describes an inherent problem with the establishment of what ultimately equates to two governments in parallel—one of internationals and the other of locals: “A unique feature impacting on the success of all BiH government policies and programs is the extraordinary power of the Office of the High Representative (OHR). This body, created by the Dayton Peace Accord, has the authority to strike down legislative acts, set policies and dismiss officials in order to counter nationalist and ethnic divisiveness. On the negative side, the OHR, with its dominating foreign influence has often been reluctant to use its authority. Even when it does, it relieves indigenous institutions and officials of the responsibility to make decisions that are best for the country, since they realize that poor or ethnically motivated decisions can be overridden or imposed by OHR.”⁵⁶ In Bosnia (and also in Kosovo) the system of parallel governments creates some perverse incentives. In particular, local authorities have some additional incentives to pursue irresponsible, populist policies (in either the economic or the political sphere), knowing that the internationals will strike down bad policies and take the blame for doing so. The mere existence of a parallel international structure, while perhaps unavoidable (both in Bosnia and in Kosovo) somewhat reduces the pressure on local authorities to act responsibly in their decision-making.

Lessons learned

- Failure to achieve a minimally rational political structure has impeded economic development at every step—fiscal management, facilitation of trade, promotion of investment, etc.
- Creating policies and institutions is as important a priority as physical reconstruction, and often a more difficult one to achieve.
- Post conflict areas should give careful consideration to adopting someone else's stable currency rather than implementing their own currency.
- Problems under the old socialist system that were not addressed after the conflict continued to constrain the economy, such as high payroll taxes, and absence of pension reform, etc.
- Channeling resources through a single account would have better allowed for recurrent and capital budgeting.
- Donor planning, preparing, and coordinating should start as soon as possible, even before peace settlements are reached.
- A system of parallel governments—one international and one local—creates bad incentives for local authorities to act more populistically and less responsibly than they otherwise would since they know that internationals will step in to block particularly bad (but populist) policy decisions.

⁵⁶ USAID / Bosnia and Herzegovina Strategic Plan Summary, October 2003.

IV. Kosovo

Background

The economic reconstruction of Kosovo was a relatively large effort compared to previous war-torn reconstruction programs (after the Marshall Plan and Reconstruction of Japan). The US was clear that the reconstruction effort would have to be international and (at least in appearance) that the economic burden for reconstruction (i.e. capital spending) would have to be shouldered primarily by the Europeans. Another aspect of the reconstruction effort was the simultaneity of the operation.

A four-pillar system was established, handling humanitarian relief (Pillar I, UNHCR), managing spending divisions for the operation of a provisional authority under UNMIK (Pillar II, the UN), organizing elections (Pillar III, OSCE), and revenue departments operating the revenue functions of the transitional authority (Pillar IV, the EU). All of them reported to the UN's Special Representative of the Secretary General (SRSG).

Several salient issues surround the reconstruction effort in Kosovo that require mention at the outset. First, it was and still is a province of Serbia. Its territorial status has not yet been determined. Rather, the UN under UN Security Council Resolution 1244 makes Kosovo a protectorate of the UN for an interim, indeterminate time.

Second, before the conflict, Kosovo had not had for some years a functioning government of any kind. As a province of Serbia it never decided its own capital budget or current budgetary expenditure, collected revenues of any significance or run a formal administration of government. That said, due to years of oppression and being banned from higher education, the Kosovars ran a sophisticated underground education network—which USAID and other UNMIK partners relied on for implementation of their programs.

In addition, as with other war-torn states, the bombing campaign of NATO and the earlier police actions of the Serbs had created a large refugee problem that burdened the economy in the initial phase of reconstruction. Furthermore, a high level of criminality existed, partially resulting from the authoritarian lawlessness of the Milosevic era, and partially growing out of activities aimed at evading sanctions and supplying weapons to insurgents.

There was no government in Kosovo even before the bombing campaign. There was a resistance movement headed by Hacim Thaci, but it was really a rebel network taking advantage of the larger Balkan war to gain independence for Kosovo.

*Economic governance*⁵⁷

The Kosovo case illustrates the importance of having an integrated economic and reconstruction aid package. While it has had its problems, and we will detail these below, USAID was much more focused in its delivery of economic governance advice. It did so early and managed to work very closely with the important allies in its delivery.

Handicapping the reconstruction effort in Kosovo was the interaction with the UN, which had never previously really undertaken the task of running a country in this way. In particular, some of the problems were focused in Pillar II where the UN itself was running line ministries such as health, education, regional development etc. The UN often used its own staff for these positions although many lacked relevant specific technical skills and experience.

Another problem lay in the legal system that was created, under which all laws (called “regulations”) were vetted through the UN Legal Office in New York before being adopted. Implementers from different institutions, each with its own legal requirements, faced problems in conducting government. For example, specific UN legal requirements made it difficult for implementers in the Central Fiscal Authority or the Department of Reconstruction to get crucial legislation passed to tax and allocate resources. As a result, the reconstruction process was slowed down.

Despite these issues, the economic governance program in Kosovo was largely well managed. Its implementers devised a budget program within 4 months of operation, as well as a financial management information system (FMIS)—which was copied in East Timor, Montenegro, and Afghanistan. This system was also introduced in Iraq but took longer than anticipated. The Department of Reconstruction also devised within 6 months of operation a detailed public investment program to guide the Donor contributions and get some control over the capital budget.

Donors committed over Euro 2 billion in direct expenditures to Kosovo between 1999 and 2002 in the form of assistance grants. Initial donor support was concentrated on crisis resolution and remediation of the inadequate physical infrastructure, such as the power and road sectors. Humanitarian assistance, such as reconstruction of housing as well as some income support measures through the payment of stipends or an emergency pension payment, were also features of the early donor financing. Capital spending was the predominant form of direct aid expenditure, and is still mainly directed to restitution rather than new capital stock. There have also been considerable investments in institutional development and the creation of a legal and governance environment in which economic activity can develop—building the

⁵⁷ This section is from the Working Level Steering Group Paper by UNMIK September 2002 cited as *Emancipation from Donor Grants: Towards a Medium-term Economic Development Strategy for Kosovo (2003-2005)*, September, 2002. The author contributed most of the economic analysis.

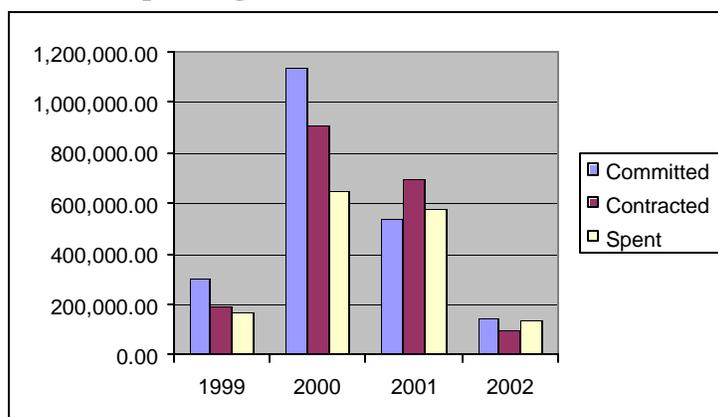
policies and institutions of a modern market economy and investing in the human capital of Kosovars in order to develop capacity for maintaining them.

Table VIII.2: Summary of estimated commitments, contracted, spending from 1999 to 2002, as of June 2002 (€ml):

| Year | 1999 | | | 2000 | | | 2001 | | | Mid 2002 | | | Cumul. 1999-2002 | | | Performance | |
|--------|-------|--------|-------|-------|--------|-------|-------|--------|-------|----------|--------|-------|------------------|--------|-------|-------------|-------|
| Status | Comm. | Contr. | Spent | Comm. | Contr. | Spent | Comm. | Contr. | Spent | Comm. | Contr. | Spent | Comm. | Contr. | Spent | Con | Spent |
| Total | 304 | 190 | 166 | 1138 | 913 | 651 | 536 | 699 | 579 | 149 | 97 | 140 | 2128 | 1900 | 1536 | 89% | 81% |

Source: Donor Coordination Unit (MEF).

Chart VIII.2: Summary of estimated commitments, contracted and spending from 1999 to 2002, as of June 2002 (€000):



Source: Donor Coordination Unit (MEF).

Immediate donor assistance focused on emergency relief: reconstructing housing, re-establishing basic services, ensuring security, etc. Even apparent capital investments were mostly of an emergency nature, for instance energy imports and funds for repairs rather than rehabilitation and expansion. A large part of assistance went into consumption rather than investment.

Quickly, however, donor attention turned to creating institutions and policies to promote economic development, and to investment (physical and human capital).

Monetary policy

Early on in the reconstruction effort of Kosovo, the EU-led Pillar working with the IMF representative seconded to work with the EU Pillar and the deputy DSRSG for the EU, made the important decisions that all foreign currencies would be accepted in place of the Serbian dinar. This immediately took monetary policy out of the hands of the UN (a good thing) and reduced all inflation to supply shocks. From then forward the Central Bank was to be a Banking and Payments Authority responsible for Central Bank operations with the exception of Monetary Policy.

Capital investment

A large share of donor assistance was allocated to reconstructing infrastructure and building physical capital in Kosovo. Some areas were:

- Rehabilitation and rebuilding of around 48,000 houses (of approximately 120,000 destroyed in the conflict), sufficient for providing homes for roughly 290,000 persons
- Rehabilitation of 450 primary and secondary schools, and refurbishment of Prishtina University
- Rehabilitation and rebuilding of hospitals in Peje, Gjilane, and Mitrovica, and reconstruction of two mental health centers
- Rehabilitation of six main bridges destroyed during the war
- In energy, reconstruction and rehabilitation of high voltage transmission lines, coal transporting machinery, electric transformers, KEK power plants A and B, and Prishtina central heating system
- Rehabilitation of Batllava water system and Kosovo-wide water system, and construction of a Kosovo-wide community water systems
- In solid waste, building and rehabilitation of existing dump sites
- Repairing of 500 km of roads
- Rehabilitation and refurbishment of central government and municipal buildings
- Renovation and expansion of Prishtina International Airport
- In telecommunication, installation of a digital telecommunication exchange

Creation of an enabling environment for investment and economic development

In addition to donor assistance that constitutes direct investment in the economy, an important share of assistance was provided in the form of technical assistance that has built a legal, policy, and institutional environment in Kosovo that enables economic development.

The importance of the general economic environment created by this assistance should not be underestimated. While at a disadvantage in many respects compared to other countries in the region, Kosovo in many ways has a far better economic environment than most of its neighbors. This environment is due largely to the technical assistance Kosovo has received from the international community, and now increasingly from Kosovar policymakers who are continuing to develop a pro-growth economic environment with their ever growing authority in economic policymaking issues. Some examples of achievements in these areas are as follows:

Taxation, Customs and Pension Reform

In 1999-2000 Kosovo introduced modern taxation, customs, and pension systems, moving rapidly from total reliance on donor support to almost fiscal self-sustainability for

current expenditures (though not yet for capital expenditures). Furthermore, this was achieved with a regime of low tax, customs, and pension rates that do not place an onerous burden on enterprises or distort labor markets. A low uniform customs rate of 10% is levied on most imports (with the exception of humanitarian and agricultural goods, and goods crossing from Serbia). The value-added tax rate is set at 15%, with a threshold of 50,000 Euro (reduced recently from 100,000 Euro). New wage-tax rates are set at 0% up to 50 Euro, then 5% up to 250 Euro, and then 10% on higher-level wages. These rates increased in 2003, and a comprehensive income tax ultimately is intended to replace the wage tax. A profit tax of 20% has been introduced. Contribution rates to the funded component of the new pension system are set at 5% from employees and 5% from employers. Overall, these tax rates, particularly on labor, are the lowest in the region, avoiding the problem of crippling high rates seen in many neighboring countries, particularly on labor, that lead to large gray economies and significant market distortions. The new pension system has three tiers: a basic old-age pension paid to all Kosovars over 65 to cover basic food costs, funded from the general budget (not from labor-based contributions); a newly established Kosovo Pension Savings Trust that collects contributions of younger working generations and supervises their investment via a competitively chosen private asset manager, and a regulatory regime for voluntary pension schemes. This modern pension system will not be subject to demographic pressure as the population ages and will promote saving and investment over the long run.

Expenditure policy

The low tax rates are enabled by a sensible expenditure policy that keeps overall expenditures low as a share of GDP, and that allocates state resources carefully based on priorities. (There is an ongoing discussion on the question of the appropriate precise expenditure level, particularly given the accumulation of surplus funds; nevertheless most would agree that an important achievement is that expenditure policy seems to be leading to a recurrent budget-sector in the range of 20-25% of GDP rather than the levels of over 50% seen in much of the region.) And current expenditures have prioritized transfers to groups in the population most in need—not only pensioners but also poor families with many children (unlike in neighboring countries where so great a share of resources goes to pensioners that little is left over for other social needs).

Expenditure problems nonetheless have arisen due to the bifurcation of government, with some functions “transferred” to the Kosovar Provisional Institutions of Self-Government (PISG) and some functions “reserved” to the UN mission under the SRSG. In the conditions of surplus as have existed in most years, this creates bad incentives, as each side struggles to spend surplus funds on pet projects before the other side can use them, thereby almost guaranteeing bad expenditure allocations.

Regulatory regime

The regulatory regime was built around four major pieces of legislation (UNMIK Regulations).

1. The Regulation on Business Organizations (UNMIK Reg. 2001/6) established a legal regime for founding and running business corporations in Kosovo. As of May 2002, more than 46,000 enterprises have registered in a provisional business registry. A full-fledged business registry is to be set up in the very near future. With further integration into the European Union this Regulation, with some amendments, is a good basis for covering the European *acquis communautaire*.
2. The Regulation on Contract for Sale of Goods (UNMIK Reg. 2000/68) has provided Kosovo with a very modern law for trans-border transactions. With very high imports and slowly rising exports, this Regulation provides basic security for businesses active in probably the most dynamic sectors of Kosovo's economy.
3. A law on internal sales transactions is still to be developed. The Regulation on Pledges (UNMIK Reg. 2001/5) is a milestone for the development of credit opportunities for the private sector, by providing the legal basis for the use of various forms of movable property as collateral. With the subsequent Regulation on the Establishment of a Pledge Filing Office (Reg. 2001/32) this Regulation has already been contributing to the development of the credit market in Kosovo. A significant number of pledges has already been registered, which means a boost in commercial banks' lending activities.
4. The Regulation on Foreign Investments (UNMIK Reg. 2001/3) is a first important legal contribution to enhancing the investment climate for foreign investors, by setting out basic guarantees for investments made in Kosovo. Such guarantees have always been high on the agenda of potential investors who have been talking to UNMIK over the last three years. A major lesson learnt is that the necessary institutional development that is needed to implement the legislation requires substantial financial and capacity building resources. Both factors, in a post-conflict environment, are more time consuming than often anticipated.

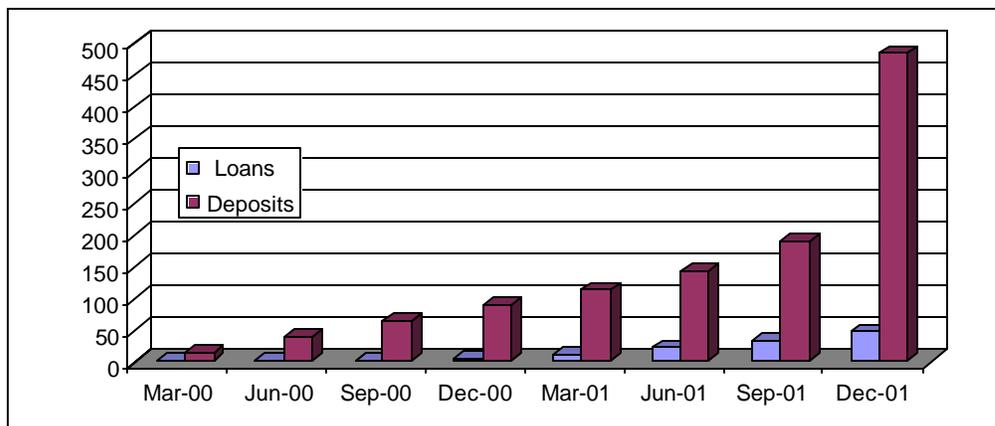
Banking and financial sector

Local Kosovar banking activities were started by Micro Enterprise Bank (MEB), which opened its first branches in April 2000. Until March 2001, this was the only commercial bank, with five branches operating in five regional centers. However, in April - December 2001, six new commercial banks were licensed (including one more with international presence—American Bank of Kosovo, subsequently sold to Raiffeisen). In addition to commercial banks, micro financial institutions (MFIs) provide bank-type (mostly credit) services in the financial sector. The number of MFIs increased from eight at the end of 2000 to 14 at the end of 2001. By the end of 2001, total credits in Kosovo were Euro 45 million: Euro 25 million from commercial banks and Euro 20 million from the MFIs. Of commercial bank credits, MEB approved the highest amount (42 percent). Of MFIs, the Interim Credit Unit of the World Bank accounted for 29 percent of total MFI credits, mostly due to its favorable terms, conditions, and interest rates.

As illustrated in the figure below, there exists a large gap between deposits and credits in Kosovo. Total credits approved by commercial banks averaged slightly more than 5

percent of total deposits, very low by international comparison. The absence of clear legal framework for property titles, poor bankruptcy laws and the weaknesses in the judicial system increase creditors' risks and therefore the cost of lending. High interest rates (up to 20-25 percent in some banks) make it unattractive for enterprises to apply for loans. As a result, Kosovo commercial banks end up depositing a high percentage of their financial assets abroad.

Chart VIII.3: Banks and MFI Loans and Deposits, 2000 and 2001 (Euro million)



Note: The high level of deposits in December 2001 was partially due to DM/Euro conversions.
Source: MEB Monthly Reports and BPK Monthly Reports

Additional examples of donor assistance in the financial sector include:

- Establishment of the Rural Micro Finance Project, which disbursed over 1600 loans as of the end of 2001
- Establishment of the Interim Credit Unit
- Support to the Agro-Business Development Unit, for credit programs for socially-owned enterprises and private agro-processing businesses

General issues

In addition to assistance that directly builds capital or that directly improves the environment for capital formation and economic development, donors have given assistance in many other areas that are of central importance to Kosovo: security, justice, democratic governance, civil society, environment, health, and education. These areas are important for the general welfare of Kosovo's citizens, and they also indirectly affect the environment for economic development. Some examples of important achievements in such areas of assistance include the following:

- Establishment of the Kosovo Protection Corps
- Organization of Kosovo's first democratic elections, both at the municipal level and at the central level

- Development of municipal government, with appropriate levels of municipal authority and intra-governmental fiscal relations
- De-mining of Kosovo's territory
- Successful municipal and central elections
- In environment, closing unhygienic dumpsites, and an awareness campaign on environmental issues
- Rehabilitation and assistance for cultural centers
- Tuberculosis treatment
- Establishment of the Kosovo Fire Service
- Reintegration of former KLA members into civil life
- Establishment of Radio Television of Kosovo, and support to regional media
- Civil registration of Kosovars and distribution of identity papers
- Establishment of the Kosovo Judicial Institute
- Police training
- Creation of an Anti-Organized Crime Unit

There was, as discussed above, some important success in the establishment of institutions and stimulating the financial sector in Kosovo. In addition, the new Central Fiscal Authority, the Banking and Payments Authority and the other Ministries established took place under adverse circumstances in a territory that had never before had a functioning bureaucracy

In the end UNMIK never really got complete control over the capital budget and there has been an ongoing committee to fuse the current and capital budget together at the now Ministry of Economy and Finance (formerly the Central Fiscal Authority). This mistake in Kosovo became an important mistake not to recreate in subsequent war-torn economy reconstructions.

Lessons Learned

- Trends in flows of donor money are key. The withdrawal of donor money from Kosovo will have a significant impact on the economy. Estimates have found that the level of dependency on foreign donor money is quite large and, if withdrawn fast, could cause a massive drop in GDP⁵⁸. The degree of foreign spending as a share of total GDP is 41%, among the highest in the world. Thus while Kosovo has done a remarkable job of instituting the proper institutions of economic governance, and brought them in fast, it never managed to rein in the capital spending of donors in a sufficient way.
- Economic reconstruction resources should be deployed early in the process. This was done well in Kosovo and paid off in the form of stability

58 Steven Lewarne and Janusz Szyrmer, *The National Income Accounts of Kosovo: Their Calculation, Composition and Implications For Donor, Revenue and, Expenditure Policies*, USAID, May 2003.

- Immediate monetary stability should be imposed. This was done through the acceptance of the D-Mark
- Kosovo fell very far short, however, of basic rules of combining the capital and current budgeting process. This was a major problem for fiscal stability and led to some embarrassingly incorrect forecasts of spending as surpluses accrued, partially because of new government agencies' inability to actually spend allocated funds.
- A national economic program should set out some basic public investment criteria. This was done in Kosovo in the Public Reconstruction Investment Program and was later improved on the Department of Reconstruction's own public investment program, but capital budgeting has remained chaotic, with capital budgeting decisions spread across many donors, rather than being centralized. The bifurcated system of government, partly Kosovar and partly UNMIK, often resulted in bad expenditure decisions.
- The establishment of utilities and the reform of the electricity provider (KEK) was very badly managed, to the continued detriment of economic development. The EU Pillar IV had the chance very early on in the process to dismiss the entire Soviet-style management structure that had dominated KEK for a decade. This would have allowed them to hire new, qualified people and at the same time revamp the sector with directed capital investment. They did not, instead inviting the old management back in, creating an entirely unmanageable situation. USAID and the US Department of Energy were, in fact, willing to pour substantial sums into this sector had it been better managed by the EU. Unfortunately, due to bad management and bad managers (including one international who embezzled millions), despite hundreds of millions of Euro subsidies, the system could not provide basic, continuous electricity.
- In telecommunications, as in electricity, bad management, regulation, and allocation of rights have led to creation of one of the lowest quality mobile phone systems in the world.

V. East Timor

Background

As the level of tensions in East Timor increased over early 1999 between Timorese and central Indonesian authorities, a compromise was negotiated, supported by the international community, to hold a referendum in August 1999 in order to determine East Timor's future status. In this vote, the population firmly chose independence. Immediately following the vote, chaos erupted. Much of the physical infrastructure was destroyed by looting and arson. Over 100,000 refugees fled the area. Administrative records were destroyed. And most Indonesians left abruptly after the ballot, meaning that East Timor lost most of its senior-level administrators.

Planning for the UN Transitional Administration in East Timor (UNTAET) was done by the UN Department of Peacekeeping Operations (DPKO). Contingency planning began in mid-1999, before it became clear what would happen at the August 30 ballot—whether East Timorese would accept Indonesia's proposal for autonomy (meaning a more limited UN peacekeeping role), or whether they would reject it (meaning a broader role as East Timor would prepare for independence). Immediately following the ballot, when independence was chosen, DPKO set up a team to plan the UN mission. The planning team had few full-time members and was caught off guard by the scope of the impending mission: It had been expected that even in a worst-case scenario, Indonesian administrators and experts would remain to assist with an orderly transition—not that they would immediately disappear.

The DPKO team was charged with proposing a mandate—a structure and tasks, to be presented to the Security Council. To some extent, planners looked to the plan for the United Nations Mission in Kosovo (UNMIK), but UNMIK was not a good model for East Timor since its administration had been split into four “pillars” (run by the UNHCR, the OSCE, and the EU, in addition to the UN, plus security provided by KFOR). In contrast, the East Timor mission was intended to be more streamlined and unified. In East Timor, the mission was to be divided into three components: humanitarian relief and immediate rehabilitation; military; and public administration. The first two were intended to be temporary, and the third component (which would include police) was intended to be ongoing for the interim period. This component was to have dual functions—of running the country day-to-day and of building capacity for subsequent East Timorese authorities to take over. The DPKO set up a consultative body called the East Timor Task Force, including both the World Bank and the IMF, which coordinated planning and presented a unified, comprehensive set of funding needs to donors at the outset of the administration.⁵⁹

⁵⁹ “Setting-up of UNTAET: Post-UNAMET, Planning, Drafting Resolutions and Finance”, in *The United Nations Transitional Administration in East Timor (UNTAET): Debriefing and Lessons*, 2003, pp. 41-45.

Planning for the future of East Timor had begun considerably before the conflict, both by East Timorese and by internationals, and both at a political level and at a more technical level. A conference was held in October 1998 in Algarve, Portugal, sponsored by the National Council of Timorese Resistance (CNRT). One set of attendees discussed high-level political issues, and another set of individuals discussed technical questions. Subsequently, a conference was held in April 1999 in Melbourne, Australia, bringing together 100 East Timorese professionals, including civil servants. A Development Plan for East Timor was produced, addressing judiciary, health, education, agriculture, economy, monetary and fiscal issues, infrastructure, language, re-employment of resistance fighters, and vocational training. From this group were chosen East Timorese who served as counterparts during the World Bank – UN Joint Assessment Mission (JAM). Until this point, the exercise was well regarded, facilitating thoughtful planning from professional East Timorese working in collaboration with internationals. Then however due to a gap in establishment of UNTAET,

not all the lessons learned and expertise of the East Timorese were passed on to UNTAET. Partially due to misunderstandings, some of the East Timorese who participated in the Melbourne conference at the technical level did not seek positions in the UNTAET civil service, not understanding that this civil service would become the government of East Timor. In general, a number of observers noted the extent to which

**Box VIII.3: Key articles of UN Resolution 1272 (1999),
creating UNTAET**

1. Decides to establish, in accordance with the report of the Secretary-General, a United Nations Transitional Administration in East Timor (UNTAET), which will be endowed with overall responsibility for the administration of East Timor and will be empowered to exercise all legislative and executive authority, including the administration of justice;
2. Decides also that the mandate of UNTAET shall consist of the following elements:
 - (a) To provide security and maintain law and order throughout the territory of East Timor;
 - (b) To establish an effective administration;
 - (c) To assist in the development of civil and social services;
 - (d) To ensure the coordination and delivery of humanitarian assistance, rehabilitation and development assistance;
 - (e) To support capacity-building for self-government;
 - (f) To assist in the establishment of conditions for sustainable development;
3. Decides further that UNTAET will have objectives and a structure along the lines set out in part IV of the report of the Secretary-General, and in particular that its main components will be:
 - (a) A governance and public administration component, including an international police element with a strength of up to 1,640 officers;
 - (b) A humanitarian assistance and emergency rehabilitation component;
 - (c) A military component, with a strength of up to 8,950 troops and up to 200 military observers;
4. Authorizes UNTAET to take all necessary measures to fulfil its mandate;
5. Recognizes that, in developing and performing its functions under its mandate, UNTAET will need to draw on the expertise and capacity of Member States, United Nations agencies and other international organizations, including the international financial institutions;
6. Welcomes the intention of the Secretary-General to appoint a Special Representative who, as the Transitional Administrator, will be responsible for all aspects of the United Nations work in East Timor and will have the power to enact new laws and regulations and to amend, suspend or repeal existing ones;

UNTAET failed to benefit from the plans and expertise of the Melbourne group. Partially due to tensions between East Timorese and UNTAET, whom some viewed as colonizers, the “Tibar Conference” was held, from which new proposals were made for joint administration, based on which the Second Transitional Government was planned.⁶⁰

In some respects, the planning for East Timor can be considered successful in that substantial planning efforts were made, with participation by donors and East Timorese. However, substantial shortcomings lie in the limited degree to which plans were actually used by the implementing mission, and in the total failure of planners to foresee or prepare for the complete collapse of government immediately following the referendum.

Security Council Resolution 1272 (1999), which established UNTAET, gave it a specific, though broad, mandate, with explicit authorization to means necessary for achieving the mandate, structured into three components. (See box.)

At the outset of the mission, the UN and the World Bank jointly produced an “Overview of External Funding Requirements for East Timor,” which served as a blueprint for donor funding priorities. As background to this document, the UN prepared a Consolidated Inter-Agency Appeal for the East Timor Crisis (CAP, 27 October 1999), and the World Bank led a Joint Assessment Mission (JAM, in November 1999). The Overview presented the broad agenda facing post-conflict East Timor: “East Timor must: manage the return of hundreds of thousands of refugees and displaced persons; begin the process of reconciliation; reconstruct homes, roads and public buildings; feed its population; decide what form of government to choose, what language to teach its children and what currency to use; and determine how to generate revenues and promote sustainable economic development.”⁶¹ The JAM tried to give a comprehensive assessment of development needs, drawing on international technical expertise from five donor countries, the UN, the European Commission, the Asian Development Bank, and the World Bank. Each international technical expert was paired with an East Timorese expert to ensure local knowledge and promote buy-in. The IMF created a macroeconomic framework and budget for the first 12 months, which would form the context of donor planning.⁶²

Economic governance

An IMF assessment at the beginning of the administration gave an overview of the state of the economy and economic institutions. It noted that the banking system was still in a nascent state, with one branch of Bank Indonesia and eight commercial banks. Around half of bank deposit liabilities were lent locally, the rest held by affiliates outside East Timor. Bank Indonesia acted as the main agent for payments clearing. The rupiah was almost the exclusive currency in circulation, with around Rp. 500-700 billion in

⁶⁰ Remarks by Emilia Pires, Coordinator, Planning and External Assistance Management Division, Ministry of Planning and Finance, East Timor, UNTAET: Debriefing and Lessons, 2003, pp. 53-58.

⁶¹ UN and World Bank, Overview of External Funding Requirements for East Timor, 1999, p.5.

⁶² Ibid.

circulation before the conflict. Before the conflict, East Timor collected around 2.5-3% of GDP in revenues domestically, and received over 5% of GDP in transfers from Jakarta. The economy was quite open, with exports equaling around 13% of GDP and imports 37% (including trade with other islands within Indonesia and abroad). During the conflict, almost all retail trade, services and government came to a standstill. Given the dire economic situation, the IMF recommended a macroeconomic framework focusing on the basics of economic governance:⁶³

- A payments system is of immediate paramount importance
- There needs to be at least some regulation of the banking sector, particularly to guard against soft credits
- A new currency for East Timor, while a reasonable medium-term goal, is not possible in the immediate term. Instead, the rupiah should continue to be used, perhaps also with a parallel international currency.
- A central fiscal authority should be created to manage government recurrent and capital expenditures, based on an agreed 2000 budget.
- The tax system must be simple and easy to administer, based on indirect taxes.
- Initial utility prices must be set, at least to cover operational costs.
- Civil service recruitment should be undertaken and wages set cautiously to be within expected future means.
- Transparent, competitive procurement procedures should be adopted.
- Donor assistance should be provided in the form of grants, not loans, so as to not unduly burden the new government.
- Establishment and management of a sound macroeconomic framework will require “substantial and continued technical assistance, secondment of resident experts, and intensive training of local counterparts, both on-the-job as well as in more structured settings.”

Two trust funds were established to manage finances, one by the UN and one by the World Bank. The UN Trust Fund was intended to finance operational costs; build basic institutions, public services and utilities; maintain infrastructure; pay civil servant salaries; build capacity; and promote the rule of law. The World Bank-administered Trust Fund was used to fund studies, training, technical assistance, and procurement of goods for reconstruction and development. A Donor Steering Committee was created over the World Bank Trust Fund, a Donor Coordination Unit to review all foreign assistance, and sectoral committees to recommend reforms in specific sectors.⁶⁴

The following areas of need were identified by an Overview of External Funding Requirements for donor assistance.⁶⁵

- Humanitarian assistance and emergency rehabilitation
- Food aid and food security
- Return and reintegration support/emergency shelter

⁶³ IMF Staff Statement, Donors’ Meeting on East Timor, Kunio Saito, 17 December 1999.

⁶⁴ UN and World Bank, Overview of External Funding Requirements for East Timor, 1999, pp. 7-11.

⁶⁵ Ibid., pp. 12-28.

- Emergency water supply and sanitation
- Emergency health
- Governance and public administration
- Rule of law (judiciary, police)
- Civil service and administration
- Establishment of governance institutions
- Economic and financial management
- Democratization (elections, constitution, political party development)
- Independent media
- Support for civil society
- Establishment of human rights institutions
- Environmental protection and resource management
- Reconstruction and medium- to long-term development
- Economic management
- Physical reconstruction of infrastructure
- Food security and agricultural development
- Income generation, job creation and micro-credit programs
- Human development
- Education

General issues

A window of opportunity was seen at the outset of the administration to address some key civil service reform issues that had important fiscal implications. Prior to the conflict, the East Timor civil service had been estimated to have around 28,000 employees, which was judged to be far excessive. The Overview recommended reducing this substantially to 12,000 individuals (of which almost 7000 would be teachers and 3000 health workers). This constituted a bold reform, taken at the initial moment of administration, that likely would have become politically impossible at a later stage in the reform process. Also, wages were set at their pre-conflict levels to avoid any distortions in the labor force that might discourage work in the private sector.⁶⁶

A number of government institutions were created/supported, including a statistics office that would generate statistics to feed into the policymaking process. To ensure economic recovery and sound economic management, a Central Fiscal Authority was created through which all government payments would be authorized and managed, and a Central Payments Office was mandated, which would evolve into a central bank.⁶⁷

Economic management was to aim at managing the overall flow of donor funds in a manner that did not lead to a negative impact on the economy. Such large donor flows of funds in such a small economy can lead to substantial economic distortions. The fact that much of the inflows were in the form of goods and services rather than cash helped to

⁶⁶ UN and World Bank, Overview of External Funding Requirements for East Timor, 1999, p.19.

⁶⁷ Ibid., p.21.

mitigate any additional inflationary pressures. Recommendations were made to discourage urban investments through measures that essentially would amount to a tax in order to not unduly sway investments from rural to urban areas. Identified needs in the area of economic management were as follows:⁶⁸

- establishing and reinforcing key economic institutions, including a department of finance and planning, procurement and audit agencies, revenue agency, statistical agency and customs offices;
- economic policy making, including the development of currency and exchange regimes, financial supervisory services, tax policy and collection systems and accounting systems;
- establishment of international agreements on the exploitation of natural resources;
- development of legal and regulatory frameworks, including an investment code, property and commercial law;
- establishment of a legal framework and lines of credit for the development of small and medium enterprises; and
- gathering baseline economic and social data, including the conduct of a population census, price surveys and a household income and expenditure survey.

Afterward, in assessing the lessons learned during this administration, the UN identified the following:⁶⁹

- Mandate. The mandate was broad but specific. UN SCR 1272 (1999) gave a mandate to: provide security; maintain law and order; establish an effective administration; develop civil and social services; coordinate and deliver humanitarian assistance; give development assistance; build capacity in government; and create conditions for sustainable government. The process was steered by the “Friends of the Secretary-General”: Australia, Japan, New Zealand, UK, US.
- Security. Security was provided by UNTAET Peacekeeping Force, supported by INTERFET, an Australian-led security effort with unified command and control.
- Law and order. UNTAET had trouble maintaining law and order. Resources were insufficient to adequately staff a sufficient number of police positions, and inadequate attention was paid to developing a sustainable legal and judicial system.
- Administration. UNTAET was tasked with capacity building for self-government—building a framework for executive decision-making and law making, and building the structures for accountable and effective public administration. UNTAET was judged to have done better at setting up decision-making processes than in building capacity and training people. It was suggested that two types of people would have been more helpful—one group of people to govern during the interim and a second group to train and educate East Timorese in order to build their capacity for governing once the internationals withdraw.

⁶⁸ UN and World Bank, Overview of External Funding Requirements for East Timor, 1999, pp. 24-25.

⁶⁹ UNTAET: Debriefing and Lessons, pp. xxv -xxxiii.

- Capacity building. At the institutional level, UNTAET was judged to have made good progress in creating a national development plan and budget system that led to sustainable budgets.
- Consultation with East Timorese. Consultation between international efforts and East Timorese was poor at the start. In particular, UNTAET planners did not benefit from extensive plans drawn up by an East Timorese diaspora group, the Timorese National Resistance Council.
- Aid and its effectiveness. Coordination and effectiveness were generally judged to be high, but problems were identified in that great pressure to move funds quickly often led to less effective assistance than when assistance was moved slowly and carefully; aid conditionality and ties to certain products impeded effectiveness; and “receiving” capacity for assistance often could not keep up with the assistance delivered.
- Gender. Gender programs were judged successful, resulting in 30% female representation in decision-making and public service positions.
- Humanitarian assistance. Emergency assistance was generally judged to be successful, even when delivered or supported by the military.
- Elections. Two elections were successfully held.
- Exit strategy. UNTAET started planning its exit strategy early, which was judged to be successful. Responsibility was passed to the new East Timor government and to the follow-on mission, the UN Mission of Support in East Timor (UNMISSET). Such planning was complicated by the fact that UNTAET had taken on the role not only of peacekeeper but also of nation builder.

According to others, however, UNTAET’s mission was judged by many participants to have been successful not because of UN planning beforehand but despite the lack of proper planning ahead of time. Because the political situation deteriorated considerably and unexpectedly at the end of the work of UNAMET (predecessor to UNTAET), UNTAET had no plan for the role it quickly assumed—that of overall administrator of East Timor. According to Sergio Vieira de Mello, SRSR, UNTAET: “While, ultimately, this transition proceeded flawlessly (from UNAMET to UNTAET), it did so because of fortunate circumstances (we had excellent people on the ground and were able to improvise) rather than because of our advance planning. We may not be so lucky the next time.”⁷⁰

A key lesson the SRSR drew from the East Timor experience is: “[I]t is vital that we develop the systems required to draw on the requisite personnel and assets for the tasks before us, and that we do so in a timely fashion. This, more than anything else, is the overriding lesson I took from East Timor and particularly those hectic early days. One

Box VIII.4: Successful administration in East Timor

“The admiration felt by many across the world for the desire for independence of the people of East Timor may explain why UNTAET was one of the most consensus-driven UN interventions to date. Few operations have enjoyed, from inception and throughout implementation, the kind of support received from the public at large as well as from the members of the Security Council as UNTAET has.” (Marcel Boisard, UN Assistant Secretary-General and Executive Director, UN

⁷⁰ Sergio Vieira de Mello, SRSR, in UNTAET: Debriefing and Lessons, p.17.

simple measure would be the development of stand-by arrangements (similar to those we have with troop contributors) with member states for the provision of pre-specified assistance at virtually no notice. This could either be in the form of essential equipment or, crucially, through making available self-contained sectoral teams (e.g., in areas such as banking, budget management, taxation, immigration, civil service recruitment, customs, penal services, veterinary services, roads, ports, electricity, health services and so on). In other words all the skills actually required to run a government. We need to be able to roll up our sleeves and get down and dirty at the coal face of administration.”⁷¹

Administrators need to be given sufficient flexibility to spend money. For instance, in East Timor at the beginning of administration, the SRSG had resources in his budget to renovate UN offices but no funds to renovate prisons.⁷²

According to the SRSG, on the need for a mandate: “Three core ingredients are required: a suitable mandate (which should not be confused with an easy one), the ability to implement it, and on the ground flexibility to adapt it as circumstances required. Where the UN mission must have authority vested in it, this must be clearly spelt out. For UNTAET, Chapter VII powers were vital to ensure that a credible deterrence capacity was in place as well as to ensure that the power vacuum in existence in late 1999 could be filled. This proved decisive and stands in marked contrast to the disastrous ‘incremental mandate’ approach in Bosnia-Herzegovina, which I was witness to.... Having a clear end-state is critical. One need only look to Kosovo as a convincing argument for this need. Resolution 1242 establishing UNMIK can satisfy neither Serb nor Kosovar. 1272 by contrast, whatever the frustration felt during the transition, made it crystal clear that the UN would be a facilitator of independence and not an obstacle.”⁷³

The SRSG also notes there were some criticisms that UNTAET should have been faster to hand over power to East Timorese. While recognizing this point, he notes in some cases delay in transfer led to better situations—such as more political parties in the provisional government, meaning a more vibrant democracy, than would have been the case with an earlier transfer. He also notes the “conundrum of devolving authority quickly in a traumatized nation with no democratic representation. (Add to this the tension inherent in the mandate between capacity building and helping prepare East Timor for democratic independence on the one hand, with the need for service delivery, as well as the fact that all powers of government were vested in UNTAET alone.)”⁷⁴

According to Roque Rodrigues, Secretary of State for National Defense: “Nevertheless, in all the writings, they all clearly identified that East Timor lacked human resources or suffered from a scarcity of qualified human resources. But despite identifying this problem, no effort was made by UNTAET to formulate a coherent strategy to address this issue. In fact, it was belatedly realized that capacity-building should have been a priority. It was only in the latter stage of the transitional period that the ‘Timorization process’

⁷¹ Sergio Vieira de Mello, SRSG, in UNTAET: Debriefing and Lessons, pp. 17-18.

⁷² Ibid., p.18.

⁷³ Ibid.

⁷⁴ Ibid., p.19.

began to take place. It must also be stated that in the beginning UNTAET personnel were not selected with Timorese counterparts in mind. Most did not have counterparts and those who did have Timorese working alongside them were not required to transfer skills to the Timorese. Therefore, a majority of the UN personnel did not speak any of the languages that were crucial to communicate with the local population and in most cases, they did not possess the skills to transfer their knowledge. This is a clear example of how capacity-building was not viewed by UNTAET as a high priority.”⁷⁵

According to Dennis McNamara, Director, UNHCR, Former Deputy SRSG for UNTAET: “I was—immediately on arrival in an unknown environment—required to take basic decisions on everything from rates for electricity charges to a national strategy for road repair and legal aid, without adequate expert advice, either international or local. UN generalists may be able to run such operations, but can do so successfully only if they have the support of qualified expertise. There is no doubt this lack in Timor was inefficient and costly in a number of key areas. The UN does not possess this in-house and must rely on donor governments and others to provide it. The military advantage is that they are—by definition—experts on standby and ready to deploy quickly. We need similar arrangements in key civilian areas and for civilian police (which are in very short supply in most developed countries).”⁷⁶

The way in which financing was centralized was considered to be a significant success of the East Timor experience. Mukesh Kapila, who advised the SRSG in East Timor, noted the following successes from this experience:⁷⁷

- Approval of an overarching budget at an early stage that gave a policy framework and set priorities.
- Early involvement by donors and East Timorese in planning and policy formulation, particularly through the JAM.
- Clear establishment of benchmarks against which to measure progress.
- Using multilateral trust funds, financially supported by the large donors—the US and EU—rather than a decentralized direct bilateral approach.

Kapila also identified shortcomings of the experience:⁷⁸

- Needs assessments were not always regarded as adequate, instead often more reflecting pre-existing inclinations of donors.
- Quality of donor assistance is often impeded by excessive or poorly thought-out conditionality.
- Some important areas, such as security, are hard to find donors willing to fund.
- Expectations of the local population need to be managed so they understand the complexity of donor funding processes and the speed at which power will be turned over to them.

⁷⁵ Roque Rodrigues, Secretary of State for National Defense, in UNTAET: Debriefing and Lessons, p.28.

⁷⁶ Dennis McNamara, Director, UNHCR, Former Deputy SRSG for UNTAET, in UNTAET: Debriefing and Lessons, p.35.

⁷⁷ Remarks of Mukesh Kapila, in UNTAET: Debriefing and Lessons, pp. 60-61.

⁷⁸ Ibid., pp. 61-62.

The World Bank assessment of the East Timor experience pointed to similar lessons:⁷⁹

- Planning beforehand started early and successfully was coordinated among donors and with the East Timorese. Key priorities were identified.
- Donor aid was moved fairly quickly, though the complexity of donor assistance funding processes was nonetheless a common impediment.
- Resources are needed both for service delivery (ie, immediate good governance) and for capacity building. These two goals often compete for resources, implying tradeoffs. And each of these tasks requires its own type of programs.

Lessons learned

A summary of key lessons learned is as follows:

- Planning and preparedness beforehand are key. Plans need not only to be made but also to be given to those who will implement post-conflict reconstruction and administration.
- Resources for current and capital budgeting are best centralized into a unified, rational process.
- Extensive resources are needed for capacity building. It is easy to focus all attention on day-to-day administration rather than the also important task of preparing local experts for their future roles as administrators.
- Politically difficult, but important, reforms, for instance public administration reform in East Timor, should be undertaken immediately while a political window of opportunity exists.

⁷⁹ Klaus Rohland and Sarah Cliffe, *The East Timor Reconstruction Program: Successes, Problems and Tradeoffs*, World Bank, 2002.

VI. Sierra Leone

Background

Since 2002, after two decades of economic mismanagement and one decade of brutal war, Sierra Leone has emerged into a period of relative peace and economic development. After steady economic growth during the 1960s, the period of 1970 to 1989 was one of poor governance, corruption, excessive state interference in the economy, and misdirected state expenditures, which led to GDP decline of over one-third from the 1970 peak. Then, from 1991, Sierra Leone fell into violence, as the Liberia-

Box VIII.5: UNAMSIL's Mandate

According to Security Council resolution 1270 (1999), UNAMSIL was giving the following mandate:

- To cooperate with the Government of Sierra Leone and the other parties to the Peace Agreement in the implementation of the Agreement
- To assist the Government of Sierra Leone in the implementation of the disarmament, demobilization and reintegration plan
- To that end, to establish a presence at key locations throughout the territory of Sierra Leone, including at disarmament/reception centers and demobilization centers
- To ensure the security and freedom of movement of United Nations personnel
- To monitor adherence to the ceasefire in accordance with the ceasefire agreement of 18 May 1999 (S/1999/585, annex) through the structures provided for therein
- To encourage the parties to create confidence-building mechanisms and support their functioning
- To facilitate the delivery of humanitarian assistance
- To support the operations of United Nations civilian officials, including the Special Representative of the Secretary-General and his staff, human rights officers and civil affairs officers
- To provide support, as requested, to the elections, which are to be held in accordance with the present constitution of Sierra Leone

According to Security Council resolution 1289 (2000) of 7 February 2000, the mandate was revised to include the following tasks:

- To provide security at key locations and Government buildings, in particular in Freetown, important intersections and major airports, including Lungi airport
- To facilitate the free flow of people, goods and humanitarian assistance along specified thoroughfares
- To provide security in and at all sites of the disarmament, demobilization and reintegration programme
- To coordinate with and assist, the Sierra Leone law enforcement authorities in the discharge of their responsibilities
- To guard weapons, ammunition and other military equipment collected from ex-combatants and to assist in their subsequent disposal or destruction

based Revolutionary United Front spread conflict across the country, first in rural areas and then in urban areas. The conflict left over 20,000 dead, thousands maimed, many women and children raped or enslaved, and over two million displaced. By 2000, GDP had reached a level of only one-third its 1970 level, and the country was at the bottom of

the UN Development Index. Perhaps 80% of the population lived below the poverty level of a dollar per day.⁸⁰

During this period, the revenue base largely collapsed, followed by the breakdown of many government programs. Over 1997-1999, domestic government revenue averaged 6.6% of GDP. And of this small pie, an ever larger piece went to security-related expenditures (4.6% of GDP in 1999), and ever smaller share to social and economic sectors (1.1% of GDP).⁸¹

As peace talks were starting to yield initial results, the UN established a presence, with the UN Observer Mission in Sierra Leone (UNOMSIL), in July 1998. UNOMSIL was given a mission of monitoring the military and security situation, the processes of disarmament and demobilization, and extent of respect for international humanitarian law. In October 1999, UNOMSIL was replaced with a much larger UN presence, with a much broader mandate, the UN Mission in Sierra Leone (UNAMSIL). UNAMSIL was charged with a mission of cooperating with the Government and other parties in implementing the Lome Peace Agreement and assisting with disarmament, demobilization, and reintegration. UNAMSIL's mandate was expanded once, in February 2000, and its size was increased twice, in May 2000 and March 2001. (See Box.)

Unlike the broader UN missions in Kosovo and in East Timor, the mission in Sierra Leone had a much narrower focus, exclusively on issues related to security and support to the peace process. The UN did not take on the broader role of directly supporting economic development that other elsewhere missions had taken.

Of the bilateral donors, DFID took the lead due to Sierra Leone's history as a former British colony. DFID's development goals are set in a ten-year Memorandum of Understanding with the government, identifying the following priorities: corruption, reform of central and local government, public expenditure management, media reforms, effective regulation of the diamond industry, security sector reform, sound macro-economic management and the development of a poverty reduction strategy.

USAID has focused on a narrower set of issues, maintaining a smaller presence than DFID. The USAID mission has two Strategic Objectives: Reintegration and Democracy. Under reintegration, assistance focuses on social, economic and physical support to encourage resettlement and reintegration in war-torn communities. This includes projects for local communities, agriculture, and public infrastructure. Under the second objective, assistance focuses on helping local communities to become involved in national decision-

⁸⁰ "Transitional Support Strategy for the Republic of Sierra Leone," World Bank, Report No. 23758-SL, 2002.

⁸¹ "Sierra Leone: Joint Staff Assessment of the Interim Poverty Reduction Strategy Paper," World Bank Report No. 22542, 2001, p.23.

making, management of diamond resources, education, limitation of corruption, and youth and gender issues. Other US assistance focuses on humanitarian issues.⁸²

Economic governance

In July 2001, the World Bank and the IMF conducted a Joint Staff Assessment and worked with the Government to develop an Interim Poverty Reduction Strategy Paper (I-PRSP), which guided the international aid effort for the following several years. The I-PRSP proposed to pursue development in two phases. In the first, transitional phase, for 2001-2002, it was intended to focus on what were perceived to be most immediate needs:⁸³

- National security and good governance. Security was necessary for all other aspects of development—creating conditions so people can go back to work, so humanitarian efforts can deliver aid, and so government programs can operate. The Disarmament, Demobilization and Reintegration (DDR) Program was one key means for seeking to achieve this. Furthermore, the state security forces were restructured. A National Security Council was created as the lead senior-level security policy body, and a Central Intelligence and Security Unit (CISU) was created to complement the army and police. The army was to be restructured and retrained by the British Defense Forces. Reforms were introduced in the police to reduce corruption. Public administration was improved through re-establishment of local governments, clarification of administrative rules, and improved monitoring.
- Re-launching the economy. Macroeconomic stability, as is always the case, was viewed as the foundation for renewing economic growth. Initial goals were to maintain inflation (CPI) around 8%, to limit the external current account deficit to 26% of GDP, and to increase net international reserves to 1.6 months worth of imports. Fiscal policy aimed to increase revenues to 11.4% of GDP in 2000 and 12.3% of GDP in 2001, through creation of an Independent Revenue Authority, and through improving direct taxation (rationalization of import tariffs to be consistent with other countries in the sub-region, in order to reduce smuggling and open trade; eventual introduction of a VAT). On the expenditure side, a medium-term expenditure framework was to be introduced. (Budget implementation was not a high priority.). Monetary policy aimed at keeping inflation in single digits, maintaining an open, flexible exchange rate, and better regulating the banking sector. Bank regulation focused on ensuring strict foreign open positions on commercial banks to encourage inter-bank trading, sales to the foreign exchange auction, and deepening of the foreign exchange market. Reduction of external debt burden focused on seeking relief under the Enhanced HIPC Initiative. Given Sierra Leone's severe debt burden, it was expected that additional relief would be sought even beyond HIPC. Development of the private sector focused on creating a National Commission for Privatization that would

⁸² USAID, US Congressional Budget Justification, 2003; and USAID, Sierra Leone Transition Strategy Phase 2, FY 2004 – FY 2006.

⁸³ "Sierra Leone: Joint Staff Assessment of the Interim Poverty Reduction Strategy Paper," World Bank Report No. 22542, 2001, pp. 26-35.

divest the state from many Public Enterprises. Sectoral policies focused on agriculture, mining, and infrastructure.

- Social programs. Social programs focused on education, health, housing, social safety *nets*, *gender equality*, and *poverty interventions*.

While attempts were made to liberalize trade, in the important area of diamond mining, the issues are quite complex. To some extent, what was needed was a *less liberal* regime. Specifically, measures aimed at establishing certification of diamond mining were intended to reduce smuggling and to gain more control over this sector.

In the area of economic governance, DFID focused attention on reducing poverty and on ensuring general macroeconomic stability. Under poverty reduction, DFID followed Millennium Development Goals: eradication of extreme poverty and hunger, achievement of universal primary education, promotion of gender equality, reduced child mortality, improved maternal health, reduction in HIV/AIDS and other diseases, environmental stability, and global partnership. In the area of macro-economic stability, DFID underscored the importance of World Bank and IMF programs and the Medium-Term Expenditure Framework. Here, DFID thought particularly important the reduction of military expenditures.⁸⁴

The most significant area of economic governance where USAID worked was on governance in the diamond sector. So-called “conflict diamonds” were a significant source of the funding for various mercenary armies over the past conflict periods, and disputes over these resources had fueled the violence. To a large extent, improving management of diamonds is the economic key to establishing sustainable political stability. Efforts to gain control over sale of diamonds, bringing their sale out of the shadow and under the umbrella of government revenues, have been relatively successful. Legally exported diamond sales have grown over time from \$1.2 million in 1999 to \$26 million in 2001, to over \$38 million in 2003. The numbers of diamond licenses granted had grown to 1400 in 2003 (compared to a target level of 850). Local governments were given a greater share in allocation of revenues from diamond sales.⁸⁵ These achievements should reduce the financial resources of insurgent groups.

General issues

The IMF-World Bank Joint Assessment of the I-PRSP noted the following areas where improvements could have been made in the Government’s reconstruction plans:

“[I]t could have been strengthened by adding gender inequality...to the causes of poverty; linking internal displacement to lost economic opportunities; analyzing to a greater extent the links between insecurity and poverty; and bringing out

⁸⁴ “Sierra Leone: A long-term partnership for development between the Government of the United Kingdom and the Government of the Republic of Sierra Leone,” Department for International Development, February 2003.

⁸⁵ USAID, Sierra Leone Transition Strategy Phase 2, FY 2004 – FY 2006.

explicitly the situation of child soldiers as a particularly vulnerable group. Also, given the fact that 80 percent of the population lives below the poverty line, using 1 dollar U.S. per person per day may not be the most appropriate measure of income poverty. The staffs therefore suggest the development of alternative, more appropriate, poverty benchmarks to monitor the impact of poverty reduction strategy on the poorest of the poor.⁸⁶

The I-PRSP was designed based on little data about poverty—mostly on a single household survey conducted in 1989-1990. Consequently, an emphasis was placed on greatly improving poverty data during the initial transition phase so that the subsequent PRSP would be able to propose better measures for poverty alleviation. According to the World Bank-IMF Joint Assessment: “In the medium term (2003-2005), the Government’s priority is to build a comprehensive information base for poverty analysis and monitoring.” This data collecting and analysis was to include a nationwide census that would survey living standards, a comprehensive poverty monitoring system, and better assessment of the impact of macroeconomic and structural policies on poverty.⁸⁷

Structural reforms on which the donors concentrated in late 1998 and 1999 included privatization of oil import operations, creation of an independent revenue authority, tariff reforms, cleaning of the civil service and pension rolls to remove “ghost” workers and pensioners, upgrading government accounting, strengthening the judicial and legal system, reorganizing the army and police, and changes in managing state-owned enterprises (including their privatization in some cases).⁸⁸

Lessons learned

- A strategy was followed of mostly focusing on immediate security issues and the very basics of restarting the economy during the first few years, under the assumption that this was all that could be accomplished initially. An alternative view would have been to also try to address some of the more important underlying economic issues as well, including more efforts to address issues in the diamonds sector, and more focus on budget implementation.
- Macrostability and an convertible exchange rate were at the foundation of building sound economic policies.
- Fiscal policy focused on increasing revenues, shifting toward indirect taxation, and building a medium-term expenditure framework (the budget preparation side rather than the budget implementation side). In retrospect, perhaps more attention should have been placed initially on budget implementation as well.

⁸⁶ “Sierra Leone: Joint Staff Assessment of the Interim Poverty Reduction Strategy Paper,” World Bank Report No. 22542, 2001, p.4.

⁸⁷ *Ibid.*, p.5.

⁸⁸ “IMF approves emergency post conflict assistance for the Republic of Sierra Leone,” Press Release, IMF, 9 November 1998.

- Significant efforts were placed on capacity building within security forces— police and army. More attention could have been spent on building capacity for economic policymaking, since this is a time-consuming development need.
- Security was rightly recognized as a key element for economic development. Without security, all other elements of economic development become both irrelevant and impossible to achieve.
- Efforts focused on reining in the diamond trade, ensuring the revenues went to state coffers rather than to insurgent groups. This greatly reduced the level of available financial resources to fuel conflict.
- The UN mandate in Sierra Leone was drawn much more narrowly than in Kosovo and East Timor, focusing almost exclusively on security rather than including economic policy. The World Bank, IMF, and USAID mostly focused on economic issues. Arguably, a better institutional arrangement might have been achieved if security and economic development were better integrated institutionally.

VII. Afghanistan

Background

While Afghanistan has had serious security problems and has a weaker intergovernmental system, it has established a comprehensive set of economic governance reforms, which, if managed well, should facilitate increased foreign assistance over the next ten years. Afghanistan is not without its problems—most notably a weak security system outside of Kabul. However, in terms of establishing the economic governance necessary for proper reconstruction, the country has made good choices, often with the help of foreign assistance.

Since the end of the military campaign in 2001, Afghanistan has managed strong real growth, introduced a new currency while managing the retirement of its old currency, set in place a fiscal authority that can account for use of all donor funds, and put a financial management information system (FMIS) in place for proper cash management of the government budget. This is a remarkable achievement among war-torn economies.

Afghanistan—and the accompanying economic governance program it has implemented through technical assistance from various donors—is at the end of a long line of learning among donors since the Marshall Plan was enacted in the wake of World War II. Donor coordination in Afghanistan, and the use of disparate sources of donor monies by the Ministry of Finance, has been well managed relative to earlier reform efforts in other war-torn economies.

An important point we make here is that Afghanistan requires public sector investment, particularly infrastructure reconstruction funded by donors (particularly the United States) and private investment to ensure that it can attract increased amounts of foreign aid in the out years to take advantage of the economic reconstruction investment that has been applied to date.

Foreign assistance levels across war-torn economies can be compared in various measures, including per capita spending in constant U.S. dollars and spending as a percentage of GDP. The level of assistance Afghanistan has received relative to other war-torn regimes is low. Dobbins has provided a useful comparison in his recent work for Rand. Germany received about \$200 per capita (in constant 2001 U.S. dollars) during the first two years after World War II. Kosovo received about \$800 per capita, Bosnia over \$1,400 per capita, and Afghanistan has received less than \$100 (the IMF estimates about \$70) thus far⁸⁹. Even Rwanda, not generally regarded as a success by any measure, received more than Afghanistan (around \$98). In order to meet Afghanistan's projected revenue requirements of \$28 billion over the next seven years, donor assistance must rise to \$1,400 per capita—on par with spending in Bosnia.

⁸⁹ James Dobbins et al., 2003.

In terms of foreign assistance as a share of GDP, Afghanistan looks better off than when donor assistance is calculated on a per capita basis. Donor assistance to Afghanistan is approximately 40% of GDP, which is higher than Bosnia and on a par with Kosovo. However Afghanistan is still below Rwanda and East Timor, which each received about 60%. The share of donor assistance to GDP is misleading and neglects the level of assistance necessary for reconstruction. Afghanistan's productive capacity was devastated over the last twenty years, and the constant war has not only destroyed physical assets but also the confidence to undertake longer-term investment by the domestic population. Currently, Afghanistan's greatest need is to achieve a required level of capital investment—most of which will derive from foreign assistance. While domestic revenue will probably grow, it is unlikely it will strengthen to the point necessary to fund the large capital infrastructure projects needed. The large real GDP growth rates of about 20 to 29% last year and in 2002 were largely a function of the low base, as well as extraordinary weather favoring agricultural output.

If Afghanistan can introduce good economic governance and maintain essential priorities in the relationships between fiscal and monetary policy and the Ministry of Finance and donor community, it will go a long way to improving its chances for long-term growth. This will contribute importantly to political stability, which is a key objective of the donor community. Thus, problems in intergovernmental finance, lack of security in the provinces, and low initial levels of GDP are economically manageable so long as consistent progress is made in improving the institutions of economic governance.

Economic governance

Use of the Budget System as a Tool of Central Policy

The present and projected revenue collection effort will likely finance the current government wage base and the recurrent expenditures thrown off by capital investments. However, the initial investments are large and cannot be met out of domestic resources. As estimated by the government of Afghanistan (GOA) in January 2004, the capital development program will require some \$26 billion over the next seven years. This will require one-time expenditures of about \$7 billion, of which only a little over half can be internally financed (\$4.4 billion). Thus, as the GOA points out, about \$28 billion will be required over the next seven years. The GOA thus makes a strong case for the increased donor financing and capital reconstruction costs to be channeled through the government budget since this will enforce the budget as a central tool of policy making.

The accurate and timely use of the budget system as a tool of central policy also has significant externalities in terms of long-term monetary policy and monetary control. Ultimately the central bank will have to deal with spending (too much of it or too little of it) by the fiscal authority. The more the budget process envelopes all revenue and expenditure, the easier it will be for the monetary authority—da Afghanistan Bank (DAB)—to respond to financial market fluctuations. In the first decade after the start of reconstruction, financial market fluctuations will be nearly entirely sourced from donor

funding and how it “hits” the economy. Standardizing it in a transparent manner makes the job of monetary policy that much easier.

Monetary Institutions and Policy

Afghanistan has made progress with each of the following tasks:

1. Introduce a stable currency. A stable currency allows households to focus on productive activity and lowers search costs. In Kosovo the reconstruction program relieved the UN Government of implementing monetary policy, so the Deutshemark was chosen as the currency. In Afghanistan, where the nation is larger and there are political considerations surrounding a national currency, a new currency was introduced. Additionally, a program for technical assistance was offered to the governor of the Central Bank for both conversion and, later, sterilization policies to maintain a managed float exchange rate policy.

2. Sterilize the inflow of donor monies and control inflation. This was done very effectively in Afghanistan (and later in Iraq). In both countries sterilization was crucial to maintaining purchasing power during the introduction of a new currency

3. Undertake commercial banking operation diagnostics. Soon after Central Bank functions are established, the monetary authority should undertake commercial banking operations diagnostics. This should be followed by bank supervision and regulation capacity building. If politically feasible, the application of foreign banks should be encouraged.

On each of the above points Afghanistan has faired very well. In large part this was due to the donor agencies’ previous experience and concerns. Crucial in this was the establishment of an intervention mechanism. This provided the necessary price stability for households as the new currency was introduced—supporting for a period the old currency’s value as the timeframe for exchanging old notes for new ones shortened. The bulk of the poorer sections of the population were unable to convert to dollars and thus saw the potential for their entire wealth to plummet if the value of the old currency was not protected during the conversion. The Governor simply intervened and sold dollars in the interim to support the old currency. When the new currency was finally fully introduced in January of 2003, the DAB had a well-functioning intervention mechanism in the exchange auction. At the same time, the DAB introduced measures to manage its foreign reserves and start the process of bank supervision and regulation.

One problem that persisted was the branch networking operations of the central bank. The DAB has focused considerable resources on establishing a national payments system and integrating its branches in all 32 provinces into a national system. This was a difficult problem to overcome and its resolution was a crucial element of the Ministry of Finance’s ability to run its payments system beyond Kabul. The security situation was just one of the serious obstacles hampering its development.

Some important tasks are ahead for the DAB, namely improving its use of monetary instruments as well as developing more sophisticated targeting; they will be dealt with in the conclusion.

Fiscal Institutions and Policy

Setting up the Ministry of Finance in line with international best practice is as important as the monetary authority. One of the main reasons is to show the donor community a transparent use of funds. For many reconstructing economies, transparency in the use of funds is the only way to guarantee a smooth review by donors. This was done within weeks of the Tokyo conference and shortly after the ADB, World Bank, DIFD and then USAID were providing departmental support in Customs, Budget and Treasury—all functions essential for a well functioning ministry of finance.

More significant than this was the precision with which the new Minister of Finance worked with the ADB, World Bank and UNDP in their preliminary assessment of funding requirements. Here the strategic objective of reconstruction programming was spelled out in 1, 2.5, 5 and 10 year terms. After they were presented with some clarity at the Tokyo conference, donor disbursements began.

It is worth noting that the amount pledged for the Tokyo round, i.e., \$14.6 billion for the next few years, is lower than the more recent figure calculated by the GOA of \$28 billion. It is precisely because of the clarity with which the new minister dealt with donors prior to and during the Tokyo conference and the systems he has put in place with the assistance of donor technical assistance that have allowed him to make the case for more funds from the donor community, with a chance of receiving them.

Another important step is establishing the ability to prepare and execute the budget properly. In many developing countries, the problem is not one of budget preparation, rather of execution. Execution is usually much more problematic than preparation in war-torn economies. This was done well in Kosovo, Montenegro, and Afghanistan. Iraq, as an illustration, focused more on budget preparation immediately, to the detriment of the preparation process.

Another important feature is to set up a Financial Management Information System (FMIS). This was an immediate strength in the Afghan reforms, learned from the Kosovo reconstruction effort, that made the treasury system much stronger and immediately transparent to the donors. Here again the World Bank recognized the need for technical assistance, and the Minister of Finance recognized the value of the advice offered.

Specific capital construction programs pushed by individual donors should be funded and phased through the fiscal authority so that there is not a separation of the current and capital budget. This was one of the main mistakes made by the European Agency for

Reconstructions (EAR) and UNMIK in Kosovo and one of the strengths of the National Development Framework (NDF) in Afghanistan.

Most significantly in all of this is the principle that the domestic authorities should take over the formulation of the reconstruction strategy at the earliest possible point in time. This occurred in Afghanistan with the result that in the composition of the first budget 2002/2003 was prepared (with World Bank and IMF assistance) under difficult and opaque data circumstances. Further, it respected a no-overdraft rule except in the third quarter and then only temporarily when donor monies arrived late. In general however, its performance in this regard has been extraordinary—especially since the spending distribution more or less stuck to the NDF sectoral priorities announced a year earlier—which displayed to donors that despite problems of a lack of remittances from the provinces of their budget obligations—a major problem that will be addressed in the conclusion—it was still not enough to offset the leading indicator of good management represented by sticking to the sectoral goals announced earlier.

Legal and Regulatory Reform

The following legislative reforms are being worked on in Afghanistan in the area of legal and regulatory reform:

- Bankruptcy Legislation
- Labor Law
- Company Law
- Competition Law
- Consumer Protection Law
- Securities Law
- Foreign Investment Law
- Property Rights Laws

These are the legal and regulatory reforms thought to be most necessary to meet international standards in key areas in order to maximize the amount of domestic and foreign investment flowing into the economy.

Additional work was planned by USAID to assist with legislation in the mining sector and also in a number of utility sectors, though these efforts have lagged behind the other legal reform areas.

Trade Policy Reform

Afghanistan is currently a very open economy, and foreign resources both at the personal and governmental level are quite adequate—so much so that supply shocks tend not to persist long. That said, a trade regime is necessary. In all the priorities for a war-torn regime, trade and openness are of course crucial – but less immediately than fiscal and monetary policy reforms. Each of the following are being undertaken in Afghanistan now:

- Strengthen capacity at the Ministry of Trade to formulate WTO-compliant trade policy
- Revive or put in place bilateral and multilateral trade agreements to provide market access for exporters
- Resolve administrative barriers that relate to inward investment and allow for smooth functioning of businesses
- Establish industrial zones to promote trade and investment
- Trade promotion, business service centers and create business associations

General issues

Afghanistan has met most of the essential criteria for the establishment of important institutions of economic governance. The donors and Afghan leaders have learned from past reconstruction efforts and focused initially and heavily on shoring up the monetary and fiscal policy institutions necessary for recovery and reconstruction.

That said, there are certain weaknesses that must be addressed quickly in order to make a stronger case for increased donor assistance. Most importantly is the credibility of the endurance and effectiveness of the existing institutions.

One important issue for Afghanistan to address is how well will the Ministry of Finance and the Central Bank operate if their current leadership leave post? Have they established a lasting bureaucracy, or, is their current success tied to the individual leaders?

Each institution has to convince foreign donors and eventually investors that the leadership is secondary to the smooth continuing operation of the functions of the institution. Two things can go a long way to instilling this confidence—one at the DAB, the other at the Ministry of Finance.

First, at DAB it is important that the central bank begin to progress beyond straight forward currency intervention. It must start to introduce and then appropriately use more instruments of monetary control and thus have a more sophisticated targeting policy. This is happening now. The DAB is moving forward with the introduction of short-term notes to restart a debt market, which will in turn assist the revival of a commercial banking sector. Once established this will become a powerful instrument of monetary policy and will mean the DAB can begin to impose financial market/wealth stability, as opposed to currency stability. In addition, the DAB (and the Ministry of Finance) need to realize how open the Afghan economy really is. Supply shocks rarely last for long in Afghanistan. This means that very little inflation is due to anything but monetary policy and treatment of currency in circulation. It also means that, with such an open trade regime, the necessary capital imports will likely appear to accelerate growth—the task of the GOA to in implementing a credible reconstruction effort is to introduce policies that sustain this openness not restrict it.

Second, intergovernmental finance is a constant problem for the Ministry of Finance. Early reports in the reconstruction process as well as recent ones have all cited this as a major problem. The IMF stated it most clearly:

The main obstacle was the lack of unity of the fiscal system due to weak central control over the provinces. Although provinces collected the bulk of domestic revenues and reported these revenues to the center, albeit with a considerable time lag, only very limited amounts of these revenues were actually transferred to the central government's accounts in 2002/2003 (about 27%).⁹⁰

This led to a collapse of the redistribution system, but more significantly it gives little confidence to donors and in turn foreign investors that this government, despite its robust Ministry of Finance with its more or less well run divisions and proper treasury systems, can manage the job of increasing the tax base and staving off long-term inflationary pressure and more immediately finance the domestic share of the reconstruction effort. It is of course good news that in May 2003 the National Security Council of Afghanistan signed an agreement with Provincial Governors to remit their proper share of tax and customs collections—but it remains to be seen that this will be honored over the long-run.

In the end it will come down to whether the donors and other key economic stakeholders believe the remarkable initial effort—despite all of Afghanistan's problems—of the establishment of economic governance can hold. Certainly a lessening of donor funds and a lessening of the military effort to maintain security in Afghanistan's provinces will seriously damage the reconstruction effort. However, if we look at the robustness of the initial economic governance reform and we attempt to seriously address the above concerns, it is likely Afghanistan will be able to stave off donor fatigue and achieve a decade or more of rapid economic and political development.

Shortfalls in Donor Assistance

Recent data on donor assistance reveals that some attention is required immediately, particularly in the level of shortfalls in some sectors. While it is encouraging that both security and transportation exceeded their required donor assistance none of the other sectors even came close to donor commitments meeting "required" resources, not to mention the low disbursements levels. For example in health and social services some \$451 million was required in 1382, yet only \$290 million was committed, and only \$154 million yet disbursed. Similarly, economic resources and management required \$323 million in funding, yet only \$233 million was committed and \$92 million disbursed. Early experience in Kosovo suggests that economic resources and management should not go under funded. It is essentially an investment in good bureaucracy building and the establishment of human capital in public sector management. This is essential for sustainable development. Finally, human resources also fell short of funding levels, as

⁹⁰ IMF, *Islamic State of Afghanistan: Rebuilding a Macroeconomic Framework for Reconstruction and Growth*, 2003 pp. 62-64.

did energy, mining, and telecommunications⁹¹. Overall as of the end of March 2004 some \$1.8 billion was required for assistance across the board, but only \$1.6 billion had been committed. Even more worrying is that only \$777 million has been disbursed. While it is too early to tell, it would be a serious setback if this is an early sign of donor fatigue.

Lessons Learned

- The Afghans focused the development effort through a National Development Framework and used the budget as the main tool of policy.
- They set up an independent Central Bank and managed well the introduction of a currency auction and new currency.
- They have not been able to establish control outside of Kabul well but there is progress in this area.
- They managed to fuse the current and capital budget quite well early on in the process, learning from the experiences in Kosovo.

⁹¹ Ministry of Finance, Development Budget and External Relations Unit, *Donor Assistance Data During Fiscal Year 1381-1382*, 2004.

VIII. Iraq

Background

The reconstruction of Iraq is one of the largest war-torn reconstruction efforts the United States has undertaken since the Marshall Plan. The Coalition Provisional Authority (CPA) has put in place several important components of economic governance, including a monetary policy (by introducing and managing a new currency) and a fiscal policy (by building a new, modern budget preparation and execution process). Also, some effort was put into addressing problems in the banking sector. Although the CPA did not give initial priority to implementing a comprehensive economic governance program, the main institutions of economic governance (monetary and fiscal authorities) have been introduced. However, the legal and regulatory regime has lacked adequate local buy-in; the trade regime has not received adequate attention. Oil-for-Food in-kind subsidies have not been monetized; and the privatization program has not been implemented.

Several problems have emerged in Iraq. For example, although there was extensive planning for post-war reconstruction, much of it was not used. USAID and other donor agencies such as DFID all had made detailed preparations for the deployment of economic governance teams, with quite detailed terms of reference. (See Appendix for the comparison of tasks and deliverables under Kosovo, Afghanistan and Iraq by USAID contracts.) While some of these tasks were eventually acted on, allowing the CPA to create a reasonable shell for economic governance, they were not acted on fast enough, and the advice of experienced development professionals was not used at the beginning of the reconstruction process.

A major theme of the lessons learned is that proper economic governance programs need to be developed at the outset of reconstruction, and that economic advisers need to be deployed quickly and systems set up immediately. The main criticism of the way the CPA built the economic governance regime and why it may face so many problems after June 30th is that it did not learn from previous USG experiences and did not deploy experienced development specialists fast enough to start building appropriate institutions. The CPA's focus was short-term (two weeks at a time) initially. In the latter part of 2003 and early 2004, the CPA was able to introduce long-term strategic thinking and, accordingly, it began to utilize more available external expertise—but this turnaround may have come too late to take advantage of the window of opportunity that existed right at the outset of the reconstruction effort.

Iraq has gone through some fairly dramatic changes since 1968. It is of some note that, despite these perturbations (the nationalization of the financial sector and the Iran-Iraq War), Iraq maintained a middle level of income per capita—albeit at a declining rate since 1979. A brief chronology follows:

- Baathists seized power between 1968-1979
 - Nationalized the oil sector (Iraqi National Oil Company)

- Nationalized the financial sector
- 1979 Iraq reported the highest per capita GDP in the region
- 1980-1988 Iran-Iraq War
- 1989 Year of reconstruction and “nominal” privatization
- 1990-Mid-2003 Gulf War and sanctions
- 1996 Oil-for-Food UN program begins
- 1997 Iraq reports living standards well below pre-Gulf War levels
- March 2003 Coalition Provisional Authority takes over

The erosion of the economy started more or less with the Iran-Iraq War and became more pronounced after the first Gulf War in 1990. At that time sanctions were put in place by the UN, and the Hussein regime began to systematically destroy the capital infrastructure. Shortly after this, in 1996, the UN introduced the Oil-for-Food Program. This program, which has been in essence a subsidy to foreign food producers, has reduced domestic incentives for Iraqi agricultural production. Some 60% of Iraqi families completely rely on food baskets compiled by the UN OFF program, while the remaining 40% rely on them in some way.⁹² The enormity of the problem OFF has created for jump-starting a private sector led market economy cannot be overestimated. An important issue, discussed below, for the new Iraqi regime will be to monetize the UN Oil-for-Food Program (OFF).

The overriding issue for Iraqis has been the steady deterioration in their standard of living and the concentration of economic activity in a very capital intensive sector. In 1989 Iraq’s GDP was reasonably well distributed. While oil was the largest sector, at 40% of the economy, services were about 29%, agriculture 17% and manufacturing about 14%⁹³. At about this same time Iraq enjoyed the highest GDP per capita in the region, at some \$US 3,600⁹⁴. By 2001 per capita income had fallen to about \$US 1200, but this was still on a par with other greater Middle Eastern States such as Jordan (\$US 1700), Syria (\$US 1100) and Iran (\$US 1300).⁹⁵ At present GDP per capita is only \$US 700-800, and oil dominates the economy (constituting about 97% of budget revenues)⁹⁶.

Thus, Iraq has had fairly precipitous decline for the last decade. The tragedy of the reconstruction effort that was started after the 2003 invasion is that this was well known to US development economists; they simply were not brought to the table soon enough to present a program for development—although such programs had already been conceived. There was nothing approaching the detail and complexity of the National Development Framework for Afghanistan, nor was there the international buy-in from the major multilateral institutions of the World and the IMF.

⁹² Frederick D. Barton and Bathsheba N. Crocker, “A Wiser Peace: An Action Strategy for a Post-Conflict Iraq,” Center for Strategic and International Studies, June 2003, p. 11.

⁹³ CIA Estimate 2004.

⁹⁴ World Bank, *Iraq: Incentive Framework for a Market Economy*, Concept Note, 2004 p.4.

⁹⁵ Economist Intelligence Unit (EIU).

⁹⁶ Stephen Lewarne, *The Role of Investment in Post Conflict Economic Development: Preparing the Investment Regime in Iraq*, Presentation to the World Bank, Trade and Investment Conference, Amman Jordan May 4, 2004.

Economic governance

Iraq, therefore, in the absence of a detailed economic plan and the late entrance onto the scene of development assistance, in any meaningful way has been playing catch-up. The particular problem a new Iraqi regime has in the reconstruction effort is that expectations need to be managed much differently than they had to be in Afghanistan or Kosovo. Most people still remember when Iraq had a per capita income above \$3000 and was the highest in the region. They also remember when it was a diversified economy and thus had a better future.

It is important to show what advantages Iraq is taking into its war-torn reconstruction effort, how some of those matter (such as good human capital) and some of them need to be managed very carefully—such as balanced growth not simply oil sector growth. It will then be necessary to show what the CPA has tried to construct in the last year, mention its strengths and weaknesses and draw some lessons from the effort.

Some of Iraq's Characteristics Relative to other War-Torn Economies

Despite all of these difficulties, Iraq has tremendous advantages over other war-torn regimes, which will help shorten the reconstruction phase considerably. The new Iraqi Regime will need to manage to retain some of the good institutions the CPA introduced very close to their June 30th shutdown date, however, if it is to succeed. Consider the following:

- Iraq is a national entity, with established membership in international organizations (IMF, WB, UN).
- Unlike Kosovo, Bosnia, East Timor, or Afghanistan, Iraq has had a nationwide civil administration that administered an economy roughly on par with the rest of the oil rich Middle East.
- The civil administration needs some rebuilding but not a major reconstruction (as it did in Kosovo, Bosnia, Afghanistan and East Timor).
- Human capital is qualitatively above that of other post-conflict economies and on a par with the rest of the Middle East.
- The humanitarian crisis in Iraq (housing and food shortages) due to its linkages to the UN and other international agencies have largely been avoided—unlike Kosovo's large refugee problem and Afghanistan's inaccessibility issues.

Each of these represent a leg up for Iraq on the reconstruction effort—in particular the human capital component of their civil service is an enormous advantage. This is combined with the oil and gas sector and the potential growth it will foster. On that point it is important to lay out the explicit advantages in this sector—but also note some extreme caution on the large inflow of donor funds.

The oil and gas sector has the following characteristics in Iraq:

- Current production is at 2 million bpd (back to pre-war levels). Pre-1991 production capacity was 3.5 million bpd.
- 112 billion barrels in proven reserves (second to Saudi Arabia) 45-100 billion in potential reserves.
- Very low production costs (when it's safe to go to the oil field).
- 110 trillion cubic feet of gas (which is on a par with Turkmenistan).
- Iraq's upstream and downstream oil and gas infrastructure is outdated and requires a sizable investment in repair, rehabilitation, and upgrading (this will be the main destination of FDI).
- In addition, large-scale investment is required to develop dozens of oil fields that have been identified and appraised, but are as yet undeveloped.
- Oil sales have already established a large reserve at the Central Bank of Iraq and in the Development Fund.

Clearly these matter for helping the reconstruction effort. But these advantages may not produce a stable economic environment and indeed may not stimulate balanced growth.

The current unemployment situation in Iraq stands at about 50%, with some 3.25 million unemployed on a labor force of about 6.5 million, and a population of about 25 million. The rapid rise in unemployment is largely a result of an atrophying GDP after the US-led invasion, as well as an extremely poor growth performance since the Iran-Iraq War in the 1980s—despite large oil wealth. Indeed, it is an important issue going forward that growth is balanced between the oil and non-oil sectors. If there is to be *both* growth and job creation together, private investment will have to be stimulated in the non-oil sector at roughly the same pace as the oil sector. This is so since the oil sector, while already growing at a rapid pace (it has returned to its pre-war levels of 2 million barrels a day), is capital intensive and cannot absorb the large amounts of unemployed in Iraq. Thus while oil can lead growth, the non-oil sector requires an investment environment that will also stimulate growth that is labor absorbing.

A joint goal for the new Iraqi government to achieve by 2010 will be to stimulate growth and increase employment:

1. At least the levels of income it enjoyed in 2001 (\$US1200) or perhaps slightly higher at \$US1400, which are of middle income status.
2. A reasonably well diversified economy where oil and non-oil are split at about a 60/40 ratio such that the non-oil more labor intensive sector can absorb most of the labor force⁹⁷.

⁹⁷ A rough scenario of growth to achieve these modest goals will be as follows:

- 10-12% growth in the oil sector to 2010 (with 2010 oil production up to 5 million b/d)
- 7-9% growth in the non-oil sector over the same period
- GDP would grow to \$US 30-40 billion

See World Bank, *Iraq: Incentive Framework for a Market Economy*, Concept Note, 2004.

For these dual goals of growth and lower unemployment to be met, a few things must occur. First, oil production will need to grow from its current rate of 2 million barrels per day to 5 million barrels per day by 2010. It is likely this will occur. Pre-1991 levels were some 3 million barrels a day, and that was under an Iraqi regime subject to strict post-Gulf War I sanctions, and several years of destructive production techniques at wells (such as large water injections into wells). With sanctions lifted, oil production will likely increase substantially fast, leading Iraqi growth.

Second, the non-oil sector must also grow at a similar pace to the oil sector. While oil can produce growth, it will not necessarily create much new employment. What is less certain is that the non-oil sector, particularly agriculture, will attract the necessary private investment for sustainable growth. Thus it is necessary that a proper investment climate backed up by an appropriately liberal trade regime, stable monetary policy and a solid fiscal revenue and expenditure base be put in place to stimulate growth in the non-oil sector such that it can absorb labor.

In order for Iraq to leverage its advantage it must have the proper economic governance institutions in place. The CPA has introduced some basic economic governance institutions—primarily the fiscal and monetary authorities of the Ministry of Finance and the Central Bank of Iraq.

Impact of Oil-for-Food Programs

The Oil-for-Food programs, discussed throughout this text, which were started in the mid-1990s under UN auspices and continued after the conflict under Iraqi government and CPA auspices, have had a profound impact on the economy, albeit one that is hard to assess precisely given the contemporaneous worsening of the security situation and other geopolitical events. According to a group of economists working for the CPA:

“[T]he Oil-for-Food program reduced the incentives for private economic activity. By augmenting the existing rationing system with imported food, the program discouraged the local production and distribution of food and other consumer items. Some agricultural sectors, such as the poultry industry, were helped because they could import feed. But small grain farmers experienced extraordinary declines in incomes, because they could not compete with subsidized grain from abroad. Moreover, because the program allotted virtually the same basket to every family, most households sold part of their rations in secondary markets for cash, because they needed different things or because they preferred better-quality items. The prices that consumers received in secondary markets were generally less than half the purchase cost of these goods, further depressing prices for local producers. Finally, by distributing food through the government’s original food-rationing program, the program maintained the link between each family and their existing food distribution agent, typically a food store or bakery. This discouraged the entry of new retail firms.”⁹⁸

The CPA economists recommended monetizing the OFF programs—that is, giving the population cash payments rather than in-kind handouts:

⁹⁸ Christopher Foote, William Block, Keith Crane, and Simon Grey, “Economic Prospects and Policy in Iraq,” *Journal of Economic Perspectives*, vol. 18, no. 3, Summer 2004, p. 53.

“One potential reform would improve Iraq’s microeconomic climate while establishing a precedent for the distribution of oil revenues at the same time. The government’s food ration system, now funded by oil sales, could be turned into a monthly allocation of cash. The funds would then provide a source of demand for Iraq’s private sector, expand the consumption set of Iraqis and establish the crucial precedent that Iraq’s oil wealth belongs to its people and not to the government.”⁹⁹

Although several proposals for monetization were circulated, unfortunately, they were not implemented, and OFF programs were not monetized, neither during CPA rule, nor during the immediate period after transition to Iraqi self-governance. The reasoning for delaying monetization was that such a reform would be too disruptive and beyond the capacity of the various institutions to achieve given the tough political and security environment. Nonetheless, it is important to recognize that a cost was incurred by not taking the step of monetization (even though perhaps impossible to measure in any precise way) in terms of reduced domestic production and the resulting impact it could have on higher unemployment and increased social tensions.

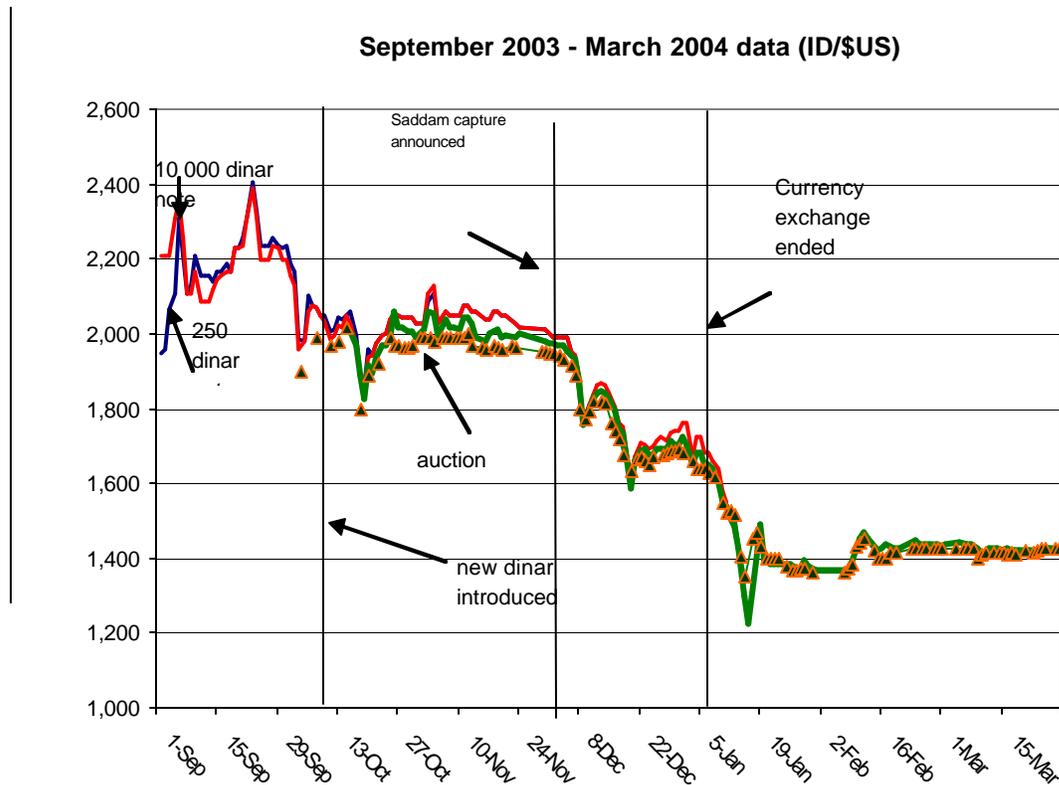
Monetary and Fiscal Policy

The most success, and where the CPA placed the most emphasis, was on monetary stability. Here it introduced a currency auction to intervene on the markets and stabilize the currency (albeit only after six months after the conflict “ended” and after much convincing by USAID and the Bank of England). It also introduced a new currency, drawing on the IMF’s and USAID’s experience in Afghanistan to both sterilize the new donor flows as well as stabilize the existing currency.

This was done very well and has had the impact of allowing the new Iraqi Dinar to reach an equilibrium of around 1400/\$US. There was a period of appreciation as so many dollars flooded into the economy, but this stabilized shortly after the conversion process ended in January 2004. See chart below:

Chart VIII.4

⁹⁹ Ibid., p. 67.



The monetary authority now has the ability to intervene and stabilize the currency, which is one of the first and fundamental economic governance reforms.

Next is the fiscal authority. Here there has been a fairly standard budget drawn up by the CPA, and it has paid particular attention to the problems of current and capital spending, as well as recognizing the revenue sources currently available in Iraq. Some of the basic precepts have been established:

- Budget Planning. A Budget passed by the CPA announcing both current and capital spending. A program that integrates all public revenues and expenditures has been started.
- Budget Execution. A Financial Management Information System (FMIS) has been established.
- Tax Policy and Administration. Tax Administration— particularly customs administration—has started, as has capacity building in administration.
- Intergovernmental Finance. A municipal, regional and national financial framework established. This is still in process, but a plan has been submitted to the CPA based on international standards.

In addition, the budget document recognized that oil revenues, by constituting nearly 97% of total revenues, is a weakness in the long-run. It further recognized the need to fund agriculture in addition to funding that would come from petroleum revenues. Some of the more important measures taken were:

- Oil revenue is recognized to be some \$20 billion by 2006 composing about 97% of revenues.
- Reconstruction levy is in place and will be phased out in 2005.
- Personal income tax has been established at a low 15% maximum marginal rate.
- Corporate income tax the same.
- User pay charges have been introduced.
- As have excise taxes, a “hotel” tax, land tax and others.

On the expenditure side the CPA tried not to make the same mistake as in Kosovo and learn from Afghanistan in that they combined the current and capital budget.¹⁰⁰ On the expenditure side they accomplished the following:

- Capital projects were included in the budget and detailed by Ministerial demands.
- Contingency reserves were set aside (this will cover such things as underestimation of the real size of the subsidy represented by the Oil for Food Program, among other things).
- Foreign Obligations were also recognized. The original budget only has reparations to Kuwait. There are also a host of other domestic and international debt obligations, which when honored, will throw off large expenses.
- However, Paris Club countries working with James Baker have reduced the total debt burden from \$116 billion to \$39 billion.
- Local and regional government finance is built in.
- It has a policy on decreasing support for SOEs which employ over 500,000 people in an employed population of 3.25 million, in a workforce of 6.5 million.
- Special nation-building capital expenses are recognized, as are special economic reconstruction programs.

While many of these steps are positive achievements on the fiscal side of reconstruction, it is not clear that any of these budget “policies” will last or that they will be adopted by a new Iraqi regime. The CPA started the programs too late, and it is unclear the new Iraqi regime will continue with this.

Overall impressions are as follows:

- Monetary policy generally has been perceived as good.
- Fiscal policy on the other hand has some concerns:
 - Need better assurance that the current and capital budget will be run through the Ministry of Finance.

¹⁰⁰ One shortcoming in budgeting was that Oil-for-Food current and capital expenditures only partially were integrated into the state budgeting process during the time when the CPA managed the country’s state finances.

- All donor money has to go through one conduit that is part of the budget construction process
- Iraq, despite its oil wealth, will not have the luxury of a current budget being able to finance large white elephant capital projects
- It is not clear the 15% maximum marginal rate will be kept in place by a new regime
- A full accounting for the unfunded pension liabilities has not been undertaken, and the extent of the all the social safety net requirements in war-torn Iraq is not known? To not have a grasp on this soon will erode confidence in a sound fiscal budget over the long-run.

Legal and Regulatory and Trade

Two other key areas are the legal and regulatory regime and trade. Here the problem is much deeper since these require confidence over time. The regime the CPA has put in place again, as with the fiscal regime, looks reasonable on the surface. The CPA has completed or is completing the full complement of commercial legislation:

- Foreign investment law
- Bankruptcy legislation
- Labor law
- Company law
- Competition law
- Consumer protection law
- Securities law
- Property rights laws

The problem is the existence of the laws themselves, rather the way the laws are being issued. Some are done with appropriate consultation, such as the bankruptcy law¹⁰¹ others are imported model laws (competition policy) that have had no relationship to Iraqi traditions, legal culture or judicial review.

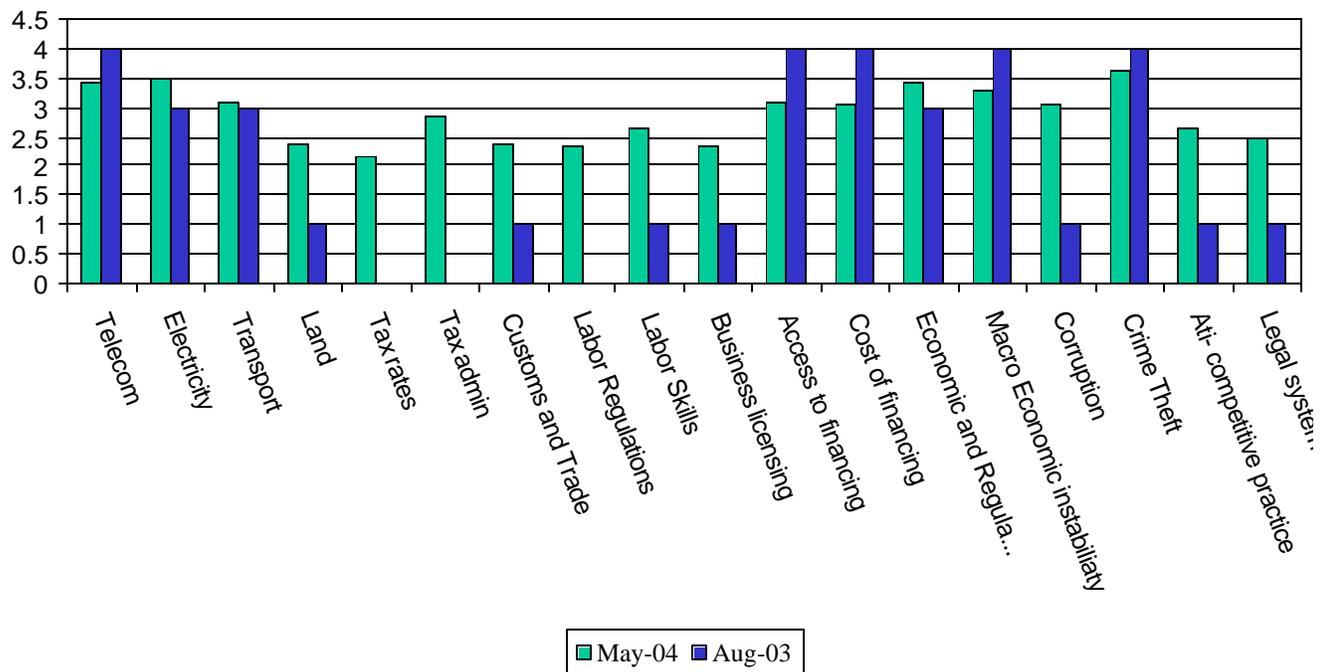
While imported model laws are not bad, they are only a starting point and require substantial domestic buy-in, which is not guaranteed. In addition a law requires implementing instructions and precedent—meaning the task of legal and regulatory reform is an iterative process—before investors believe them credible. The legal and

¹⁰¹ The bankruptcy law was gone about in a consultative and thoughtful way for Iraq: A group of Iraqi lawyers and foreign consultants worked on the amendments to the old bankruptcy law and circulated them among domestic and foreign agencies, including Iraqi bankers, judges and the World Bank. One of the most important amendments to the law is a clarification that secured creditors will rank first in the distribution of assets of a bankrupt company. Other amendments include softening punishments for managers of bankrupt companies -- which included imprisonment and prohibition from holding various jobs -- and encouraging negotiated work-outs between a debtor and its creditors. A troubled company will have protection from its creditors while it negotiates a reorganization plan which the creditors can then vote on -- a process generally similar to the U.S. Chapter 11 bankruptcy procedure. Under other amendments, Iraqi courts will be authorized to recognize cross-border bankruptcy procedures, for instance when a multinational company working in Iraq gets into financial trouble.

regulatory regime requires some very serious review. This is a tougher sell to investors than the establishment of a fiscal and monetary authority, since it relies on long-term enforcement and long-term Iraqi buy-in.

In a recent review of investors, Iraqi government officials and Iraqi consultants identified several areas of increased investment climate constraints since last year. In particular, there was a significant increase in the regulatory area as well as an increased perception that corruption could start growing. Infrastructure was not rated as serious an impediment to investment as last August 2003. The categories are ranked on a scale of 1-5. These are an ad hoc sampling, but their logic and how they fit with the changes over time is remarkable. Table VIII.3 below shows the ranking on a scale of 1-5 (5 being highly constrained):

Table VIII.3: The Investment Climate in Iraq



Some of the areas mentioned in May 2004 simply didn't exist in August 2003, such as taxation and tax administration. What is of note is that reservations over customs and trade regulation, labor regulation, business licensing, land registration have all significantly increased since August last year. The good sign is that the macroeconomic environment has improved, as has access to finance (reflecting the liberalization of financial markets by the Central Bank of Iraq in March 2004). Infrastructure issues were either similar to last year or improved (as was the crime index).

The trade regime has been a bit more straightforward. One would expect that to occur anyway since the fall of a dictatorship usually implies an opening up of trading relationships. Some of the more significant things that occurred in trade were:

- 1984 Customs Law is upheld with revisions
- CPA Order No. 54 on Trade Liberalization issued 02/04: Customs, tariffs, duties and import taxes suspended until the new Iraqi Government comes into effect (this extends the original June 03 policy). Updates parts of the 1984 Customs Law—particularly in customs valuation (largely to accommodate the Reconstruction Levy).
- Trade Bank of Iraq set up to facilitate the import and export of goods and services (CPA Order No. 20).
- The Trade Bank of Iraq has issued over \$175 million in letters of credit to international suppliers in order for ministries to import essential goods and equipment. There are over \$120 million more in letters of credit pending issuance. (To put this in perspective \$295 million is roughly half the value of the 2004 budget deficit, or double the needs for housing reconstruction.)
- WTO approved Iraq's request for observer status in February 04.

These are pretty standard reforms for trade. Nothing has been seriously implemented in the form of a trade regime in Iraq since the invasion, other than lowering tariff rates and starting a trade bank. Observer status at the WTO is important, but much lies ahead for this to lead to any fruition.

The problem here is not one of form but of substance. Can the fiscal regime put in place by the CPA for a proper budget management be maintained? Can the legal and regulatory environment the CPA has tried to put in place in the last few months take hold? Will the flat tariff rates and WTO observer status lead to membership? (The major oil producing states of the Middle East are not members, and accession takes a considerable amount of time even under good circumstances: Jordan was one of the fastest, and it still took almost 2 years. Average accession time is 5-7 years).

One answer of course is that the effort is not over. USAID will be introducing large technical assistance programs in economic governance to the new Iraqi regime. It is hoped that, when this assistance is implemented by a cadre of development professionals in cooperation with the Iraqi government, it will focus on *de facto* capacity building (substance) over *de jure* institutional creation (form).

General issues

Dutch Disease and Iraq: Understanding a war-torn economy's major future problems

Several of the donors, in particular the World Bank, have observed the coming problems of unbalanced growth if economic governance is not carried through. This will cause

Dutch Disease, and the implications for Iraq will likely be more instability despite greater wealth.¹⁰² The reason is that Iraq must reduce its high level of unemployment from 50%. If this is not done, political problems will emerge for the new Iraqi regime.

Several things are clear now as we view the reconstruction effort in Iraq from the point of view of balanced growth.

Petroleum will dominate GDP for several years and will receive most of the FDI. This means the industry has a steady cash flow to reinvest in its own capital reconstruction needs. Agriculture, on the other hand, requires relatively more assistance for its reconstruction and has to contend with a decade of deterioration due to the Hussein regime's neglect, as well as property displacement among farmers that needs to be legally resolved. More importantly, the presence of the OFF program has ruined domestic production incentives and artificially lowered prices. It is going to take a substantial effort and considerable time to replace depreciated agricultural capital as well as settle land disputes.

Even more difficult for the CPA is that it is taking more time than was originally anticipated by the CPA to monetize the OFF program, converting it first from a subsidy to foreign food producers to domestic producers and then eliminating the need for subsidy through agricultural reconstruction.¹⁰³

The OFF program also covered non-agricultural production and procurement (some 75% was actually non-food), with similar incentive dampening and distortionary effects. The manufacturing and services sectors are equally affected, and like agriculture, but unlike petroleum do not have a large and steady cash flow for their reconstruction. Iraq therefore for the next 5-10 years will be a "one-crop" economy (in petroleum) while it attempts to rebuild the infrastructure in the other sectors.

The level of reconstruction required in Iraq will absorb nearly all of the foreign exchange as they import substantial capital reconstruction materials to replace deteriorated

¹⁰² The Dutch Disease is explained as follows: Huge oil wealth brings with it large foreign exchange earnings and the majority of economic activity in the capital intensive oil sector. This raises the value of the exchange rate making manufactured and agricultural goods for export less competitive with other nations—stifling job creation in the manufacturing and agriculture sectors. This in turn raises imports stifling the creation of jobs in import substituting activities. The non-oil sector then is unable to absorb the excess labor and so we are left with a very wealthy country that is no where near its full employment level. Governments tend to react by overly subsidizing the unemployed making it more difficult to lure them into the workforce which also stifles non-oil business formation. When there is a shock such as a decline in the oil price the pain of adjustment can be severe and for some time high unemployment and high inflation persist together (stagflation), as the lowering of subsidies (because the government has less income) force people into the workforce, and the relative costs of imports (which makes up much of the consumption basket) rises.

¹⁰³ One of the key examples of CPA lack of preparation is its still inability to monetize the OFF Program and indeed its lack of planning in taking over the OFF from the UN in November 2003. This resulted in the CPA requesting the WFP to stay in place and help them administer the program. They still have not devised a full transfer program for its monetization.

industries and replace war damaged infrastructure. If the reconstruction program is managed properly, the non-oil and gas sector will absorb substantial labor involved in the reconstruction process. At this point in time however, given the tenuousness of the CPA institutional basis, one can be skeptical.

Lessons learned

- A primary lesson out of Iraq is not that although the CPA had the benefit of good governance experience in war-torn regimes from Bosnia through Afghanistan, they frequently did not draw on it.
- The CPA professionals did not avail themselves of the vast array of technical assistance available to them in a timely manner (especially from USAID). They waited too long until the security situation deteriorated, and then ushered in reforms that, while looking good, require some serious buy-in from the Iraqis. This should have happened much earlier.
- The CPA budget advisers focused too much on budget preparation rather than execution. One could argue that the security situation in Iraq made this too difficult, but the lack of execution mechanism in place will be a problem in the out years.
- A specific problem in the legal and regulatory regime was the inadequate domestic preparation of the laws. Other than bankruptcy, most of the laws were imported as model laws, and, while this is a useful starting point, it is only the beginning of a long process.
- Even more fundamentally than the above was the lack of a National Development Framework—to be enacted as a working document for the new Iraqi regime to take over. This is particularly disappointing in light of the fact that Afghanistan had just gone through the same exercise a year earlier, and has met considerable success (albeit in relative terms).
- The CPA failed to take advantage of the brief political window of opportunity to monetize Oil-for-Food subsidies. Without such reforms, vast amounts of in-kind subsidies in the form of imports will continue to be dumped on the domestic economy, harming domestic production (particularly in agriculture) and reducing employment opportunities.

ANNEX I
Comparative USAID Economic Governance Projects' Categories
Kosovo (1999), Afghanistan (2001) and Iraq (2003)

| Kosovo I¹⁰⁴ | Afghanistan | Iraq |
|--|--|--|
| Budget planning | Budget planning | Budget planning |
| Procurement | | |
| Budget execution | Budget execution | Budget execution |
| | | Intergovernmental fiscal relations |
| Macroeconomic analysis | Macroeconomic analysis | Macroeconomic analysis |
| Tax reform | Tax reform | Tax reform |
| Tax administration | Tax administration | Tax administration |
| Commercial law, legal and regulatory reform | Commercial law, legal and regulatory reform | Commercial law, legal and regulatory reform |
| Payments system | Payments system | |
| | Central bank operations | Central bank operations |
| | Currency conversion/currency exchange ¹⁰⁵ | Currency conversion/currency exchange ¹⁰⁶ |
| Commercial banks and non-bank financial institutions | Commercial banks and non-bank financial institutions | Commercial banks and non-bank financial institutions |
| Privatization | Privatization | Privatization |
| | Trade policy | Trade policy |
| | Competition policy | |
| | | Competitiveness |
| | | Securities markets |
| | | SME lending |
| | | Oil-For-Food reform |
| | | Social policy |
| | | Agricultural reform |

A few comments are in order. First, we can see that the list of categories and their coverage gets more extensive with each bid. This is a result of the learning process experienced by USAID in the implementation of successive reconstruction efforts. The Afghan and the Kosovo programs are very similar. Their differences are that Afghanistan

¹⁰⁴ It is important to note that Kosovo has gone through 5 iterations, adding and improving on the original economic governance project outlined above.

¹⁰⁵ This activity was added to the contract shortly after award and was meant to assist the already operating USAID project in currency conversion and the IMF in its exchange auction assistance at the central bank of Afghanistan.

¹⁰⁶ Task added after the award of contract by contractor lobbying the CPA.

has commercial bank, payments *and* central bank operations, while Kosovo has only commercial banks and payments assistance. This reflects the fact that Kosovo had no monetary policy to worry about since it adopted the D-Mark in 1999 to avoid these problems.

The table shows that the tasks and deliverables in the Afghan RFP were more extensive than the Kosovo one, reflecting the lessons learned in Kosovo. The Iraq RFP is a very comprehensive set of economic governance reforms, ranging from the standard fiscal and monetary reforms to competitiveness, Oil-for-Food and SME lending. While the competitiveness tasks were a bit premature given the war-torn economy problems, the intention of the insistence (and this is reflected in the SME lending) was firm level assistance and job creation.

The currency exchange task was only added after the contractor lobbied the CPA extensively to include this crucial function, in order to not have a disaster in the introduction of the New Iraq Dinar. USAID learned this first hand from Afghanistan-- that without the intervention mechanism set up during the conversion process, the old existing currency could erode in value and reduce drastically the purchasing power of millions of people during the four month long conversion process. They also needed the exchange immediately after conversion completion and then as an intervention mechanism. This was not an easy sell, and originally the CPA had said they did not see a reason for this task. Fortunately USAID's advice was taken.

Unfortunately less than half of what USAID proposed to be done on this economic governance list was approved by the CPA in the initial phase. They preferred to turn the project into a service provider for the CPA, and it was only in the last few months that the CPA started to accept the logic of the tasks outlined in the original USAID RFP.

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