

**USAID ECONOMIC GROWTH OFFICERS CONFERENCE  
OCTOBER 15-19, 2007  
WASHINGTON, D.C.**

Session Title: Rebuilding revenue and expenditure control in post-conflict countries

Date and Time: October 16, 2007, 2:45 p.m.

Type of Session: Breakout

Speaker(s): Mark Gallagher, Agim Krasniqi, Budget Director, Kosovo MFE

Moderator: Paul Davis

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Overview of Session:

- Mark Gallagher presented a matrix of how to sequence revenue and expenditure control in post-conflict countries. The first and most important thing to consider: diversity! Understanding the country context is critical.
- Kosovo's experience has been instructive: pension reform in particular was done well – in part because the decision was made to invest pension monies overseas, rather than in the fledgling Kosovar financial markets.
- IT modernization can be a stealth way of improving revenue collection—there is rarely much political pushback, and the returns can be impressive. In Bosnia, the tax administration recovered \$162 for every single USAID program dollar.
- Water flows up in Nova Scotia—but that is the only place.

Speaker's Remarks:

**Mark Gallagher:**

Societies cannot develop without the appropriate fiscal infrastructure. This presentation, which is based on a paper being developed on the same topic, asks: how can we sequence what to do in the future? How we learn from USAID experience? We look at case studies briefly, then at commonalities, and lessons to learn. Technical areas cover tax policy and tax administration, customs modernization, public expenditure systems and treasury, receipts management, fiscal policy capabilities, transparency and reporting. Countries covered include Afghanistan, Liberia, Angola, Bosnia, El Salvador, Guatemala, and Kosovo.

*Commonalities*

Post-conflict countries have high spending demand, weak revenue systems, lost tax bases and high informality, insufficient control of revenues and expenditures, and a lack or loss of capable people. Trust is not there. Anything a Muslim Bosnian thought was considered a bad idea in the eyes of the Serb. In El Salvador, you had a great schism between classes; not a racial or ethnic division, but an ideological division. In Guatemala, they took steps to rebuild trust: a fiscal pact. He would like to see it reproduced elsewhere.

Another commonality: there is corruption up and down the ladder. In Bosnia, smugglers were basically national heroes. Shortly after the conflict, the UN set up institutions to hunt them down.

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*Recommendations*

1. Donor coordination is very important: it seems to be going fairly well in Liberia; in Bosnia, so-so; in Kosovo it could have been better. In Guatemala and El Salvador, USAID worked largely alone.
2. Diversity and the need for country specific-information: In our quest to learn from our experiences, we also need to understand each country conflict. Why was there a conflict, and how does it affect reconstruction?
3. Control on receipts
  - For example, in El Salvador, a USAID IT advisor developed a point-of-sale system that provided a complete reconciliation of who paid what, what they paid for, and what are the documents that go along with it. This gave credibility to the receipts system, moved the whole flow of revenue up by 45 days, and eliminated the fiscal deficit in 1993. This was really a big bang for about \$100,000. We needed a waiver, because we had to procure the stuff in Guatemala.
  - Jim Westrick in Liberia did something similar. Money was leaking away after payment; that has now been largely reigned in.
  - In Bosnia, they had to eliminate the payment system; they set up a revenue allocation system to have control over receipts. He has never seen an RfP where they talk about setting up a receipts management system. In Bosnia, El Salvador, Liberia, they are all ad hoc.
4. Control expenditures and develop the treasury.
  - Unitary treasury system, where all payments go in to treasury and all payments come out of it.
5. Need to focus on indirect taxes first: customs duties and sales tax (or VAT if you have it). These will be the first revenue sources. Do not get too far into direct taxes, but look at them.
6. Need a good understanding of fiscal policy issues. Usually you have got a tax system in place, but it may not be reasonable. Keep your eye on the policy ball. In Bosnia, nobody was looking at tax policy. They had not even translated the laws. If you added up all the taxes on income, they would come to 65% of income.
7. Need a holistic view. It is not enough to have donor cooperation: you need someone who is not just a tax advisor, or a budget advisor, etc. to be able to take this holistic view.
8. Need to extend to NGOs: try to build trust by including civil society. Guatemala's fiscal pact set a bunch of worth-achieving targets: raising effective taxes by 50%, setting targets for reducing disparities between urban and rural sectors, and setting targets to reduce poverty through specific spending patterns.

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9. Bounce: Guatemala was so used to war for so long, that when the war ended, they kept moving along in the same way. El Salvador had a nice bounce after the end of civil strife. Angola had a bounce: their economy is the fastest growing in the world. Liberia does not have a bounce – though they did have one when Charles Taylor came in, they have not had one since. Kosovo never bounces, except along the zero growth rate trail. But maybe once people know what Kosovo will be, this will change.

The following chart gives a sense of sequencing fiscal interventions following a conflict:

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

Expenditure control: you've got to get on that immediately.

Receipts management is one of the first things you do.

Fiscal policy capacity: you should be working on this from the start. Begin looking at issues of how tax system interacts with your economy – how will you be spending your revenues, what revenues are you receiving?

Economic & fiscal statistics: though be careful - in Nicaragua, the last thing they wanted was good national accounts, because they would lose their IDA eligibility.

Reform of tax policy – focus on this in the intermediate stage.

**Moderator:** The problem was less of coordination, but of USAID's lack of success in convincing other donors in Kosovo that Kosovo is no Nova Scotia (where water flows up).

**Agim Krasniqi, Budget Director, Kosovo MFE:**

In 2000, donor support in Kosovo represented about 80% of GDP; today 20%. In 2000, 75% of the budget was covered by donors. By 2003, the budget had become fully financed.

The budget is by far the most important element of public policy in Kosovo, (there is no monetary policy). The existing system allows for no government borrowing, government debt, or contingent liabilities. The budget must balance.

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There is a big emphasis on importance of public expenditure management. The budget is designed with in a sophisticated MTEF. They take a Public Investment Programming approach to identifying project spending priorities across all line ministries. There are dialogues between the Ministry of Finance & Economy and line Ministries throughout the budget process. It is a very open and transparent process, starting with budget circulars. Spending ceilings are set in negotiation with IMF.

The treasury system is founded upon the Law on Public Financial Management and Accountability (one of most important in the country). All budget organizations, including municipalities, are linked directly to the Central Treasury System, (using Free Balance). In 2003, all local municipalities were connected. By 2006, everything was linked.

Payments come first from commitment. 95% of all payments are transmitted electronically through the Central Bank of Kosovo. There are 37,000 vendors entered into the system, and linked to unique bank accounts. They have trained more than 1000 people to use Free Balance software. The system provides real-time information for reporting and decision-making (giving immediate access to overall cash-flow situation).

*Challenges*

Post-status: the goal is to avoid compromising good systems and put good practices into place. They intend to use the budget to keep Kosovo on a sustainable development path. They must ensure that there is sufficient capacity in place, particularly human resources.

**Key Points Discussed During Question & Answer Segment:**

**Q:** Question on contingent liabilities: the issue of no overdraft is clear. Recent policies are to go after the current pension reform (defined contribution section), you will have a contingent liability. Does that mean that the BearingPoint advisors could use that contingent liability strategy to block the law?

**A:** We work on a cash basis now. Our allocation will expire Dec. 1<sup>st</sup>.

**Moderator:** The fundamental nature of the reform of the pension reform in Kosovo relates to 2 factors:

- 1) We began with a tabula rasa; we did not need to construct a fully funded pillar (pay-as-you go-pillar), which made it easier from a fiscal sustainability perspective.
- 2) Contributions only totaled 10%...good for competitiveness. We were able to put in place a flat monthly payment to all elderly citizens. We had the ability to separate out the social contribution system into an earmarking system for social insurance stabilization payments, and an income stabilization program tied to age; and we had the ability to put in an overlay of a Pay-go system. This was all critical to put together an ambitious fully funded pension pillar. It is important for AID to determine a political economy strategy to keep that in place.

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**Q:** Incentives to reform – sometimes folks don't want to reform. How can folks move forward? Is the answer MCC money? No, that's not the goal; the goal is to create a good payments system. Second question: pension fund money was invested offshore, not in Kosovo; banks in Kosovo argued that they needed to finance Kosovar businesses: where is that at, and how could it be resolved?

**A – MG:** We studied seven countries and the role of the donor community varied but one thing you find in all of them: the donors are often in a very strong position. (This is different from the political economy elsewhere.) The incentives are easy in those countries – just go do it.

In El Salvador, there was a real embracing of change: “War is over, we can't do things that way anymore,” (though the rich and poor still do not want to pay taxes). The politics of reform in El Salvador required a lot of consensus building. In Guatemala, we had been doing tax reforms since the late 80s. There were people that had shouted at each other, but they came together through the Fiscal Pact, something we can learn from: a good mechanism for bringing people together.

**A - AK:** Kosovo is still under UN rule; pension funds are still not under our control.

**Moderator:** There was a lot of discussion when pension reform was introduced in Kosovo. The prime objective needed to be protecting the stability of the funds. In that context, there were a limited set of investment options; so determination was made to invest all of the funds overseas. Development of the fund and successful governance structure bears out the wisdom of that decision. The path moving forward, (how to change guidelines for letting a portion of the funds back in), will need to be continually evaluated based on sense of financial markets. It would have been a disastrous decision in early days to have invested internally.

**Q:** Louise Cord surprised us by saying that to have pro-poor impact, one of the most important things is the public expenditure management system.

- 1) pay salaries of civil servants
- 2) provide services to population

What he has detected in a big way in places like Liberia: often there is either already a huge cadre of unskilled people, or perhaps in Kosovo's case, too many people that get built into the bureaucracy. The IMF criticized Kosovo for having too many public employees. Can you tell us what happened, and can you use your powers in the MOF to force that kind of adjustment on the line ministries?

**AK:** IMF did make that recommendation, yes. Other Kosovars agree with the IMF on over employment in government. The most recent agreement is to cut public employment by 3000.

**Q:** E-registration system: IT systems are pretty benign. Is it difficult to get those systems put in? They can generate some unwanted transparency.

**MG:** In Bosnia, we implemented IT systems, even where it was difficult. Over 3 years, we had an increase of \$162 for every dollar spent on the program. In Bosnia, sales tax revenues and

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other revenues doubled over a 4-year period in pretty-much real terms because it is a Euro-linked currency. IT really had a big impact.

In Liberia, nobody knew what was going on. In El Salvador, when we put the receipts management system in, these were seen as purely technical approaches, no hoopla about it at all. Even the banks embraced it. Sort of like stealth reform.

**Q:** Right-sizing, and how it is done can have enormous impact. There was big pushback to layoffs in Liberia because there was no alternative employment. But by eliminating ghost employees, most were able to get 30% of their payroll reduced and they could double the base salary. All 3 of counterparts volunteered that they would be willing to change their composition, to accomplish goals.

**MG:** Revenues have increased dramatically to match that salary increase. They've got 1/3 the revenues of Afghanistan, which is 15-20 times its size. Revenues come in from taxes and customs. They're getting almost no assistance in tax and customs.