FROM THE AMERICAN PEOPLE

LESSONS LEARNED ABOUT ECONOMIC GOVERNANCE IN WARTORN ECONOMIES

FROM THE MARSHALL PLAN TO THE RECONSTRUCTION OF IRAQ

ABSTRACT

This brief summarizes a much more detailed report authored by Stephen Lewarne and David Snelbecker. It analyzes eight case studies of U.S.-supported economic governance projects for wartorn countries between 1948 and 2004—their successes and failures, lessons learned, and their implications for the future design of similar projects. In addition to programs applied to Germany and Japan after World War II, the paper reviews economic governance programs in Bosnia, Kosovo, East Timor, Sierra Leone, Afghanistan, and Iraq. The authors conclude with 26 lessons relating to economic governance programs for postwar economies. The first 13 address general lessons on the importance of preparedness and effective planning; private-sector–led growth; security; sound economic data; sequencing; and other issues. The second 13 lessons are concerned with basic pillars of sound economic governance: macroeconomic and financial stability; exchange rate and inflation policy; good budget execution and balanced and efficient fiscal and tax policies; robust legal and regulatory regimes; equitable social policy; and appropriate sectoral policies.

OVERVIEW

Economic governance refers to the policies, laws, regulations, institutions, practices, and individuals that determine the context in which a country's economic activity takes place. This report advocates the early delivery of technical assistance in economic governance in wartorn economies. Timely assistance of this type is necessary for the reconstruction of economic institutions, the establishment of sound economic policies, and the creation of the capacity for sustainable functioning of a rebuilt state. It thus fosters the conditions for economic recovery, employment, and growth that puts a country back on a path of recovery and development. Macroeconomic stability, sound fiscal policy, and other policies and institutions 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.

Economic Cooperation Administration

A poster for the Marshall Plan, which applied well-thought-out economic governance programs to wartorn Europe.

Sound economic governance is the key to remedying underlying tensions, putting conflict in the past, and moving forward with economic development. Failure to establish good economic governance early on limits the possibilities of changing the underlying social relations that had led to conflict and increases the chances of continued or renewed conflicts.

During the early stages of postconflict assistance, there is often a brief window of opportunity to make fundamental changes—a window that closes when various interests consolidate political power. Many key reforms are politically challenging and best undertaken immediately, while potentially opposing interests still are relatively weak. Further, the early introduction of well-targeted, comprehensive economic governance programs can make use of donor money that will typically become more scarce after a few years. There is every reason to set up appropriate economic governance institutions to maximize its use.

The report's conclusions emerge from eight case studies of wartorn economies that cover the span of U.S. reconstruction assistance from 1948 to 2004. The first two concern the reconstruction of Germany and Japan after World War II, where the United States, largely on its own, applied a comprehensive reform approach and well-thought-out economic governance programs. The remaining case studies summarize economic development projects in the following countries and periods:

- Bosnia in 1995
- Kosovo in 1998–99
- East Timor in 2000
- Sierra Leone after 2000
- Afghanistan after October 2001
- Iraq after March 2003

ABOUT THIS BRIEF

The long report, *Economic Governance in War-Torn Economies,* was authored by Stephen Lewarne and David Snelbecker, TSG, The Services Group. It includes references, and is available online from USAID's Development Experience Clearinghouse <http://pdf.usaid.gov/pdf_docs/PDACG436.pdf>.

This brief was prepared by Hilary Russell, International Business Initiatives.

LESSONS LEARNED

The case studies focus on U.S.-supported economic governance projects and their successes and failures, how they fit into the complex web of other bilateral and multilateral donor efforts, lessons learned, and implications for the future design of economic governance packages. The review seeks to inform donors on how to create an optimal reconstruction effort and stimulate economic growth as soon as possible, even in adverse conditions.

Economic governance programs must be part of the initial sequence of reconstruction. Donors should invest in them, and specific economic governance tasks need to be accomplished. Further, economic governance is one area where, with sufficient resources wisely spent, meaningful progress can be made within a short period.

But while immediate and consistent attention to economic governance is a necessary condition for success, it is not a sufficient condition. Reconstruction efforts must be organizationally well planned and well structured, with streamlined hierarchies of command. Whether one donor or several contribute to this organizational structure is of much less consequence.

SECURITY

Economic governance issues are closely tied to security issues, since reconstruction, economic growth, and development require security. 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. Where countries had been under sanctions, criminal groups have often emerged that earlier thrived on evading sanctions. Postconflict programs thus need to make a considerable effort to fight organized crime, which otherwise can corrupt the democratization process or, at a minimum, greatly impair the environment for domestic businesses and foreign investors.

Where sanctions or other restrictions on market activity have created opportunities for criminality, economic reforms need to focus on restoring market conditions so that legitimate business can function. A vigorous policing effort is also needed. 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.

SEQUENCING

The traditional view of sequencing has been to put activities such as establishing security and providing humanitarian assistance first. Economic reforms follow later, and institution building and capacity building wait until the last stages of development. However, many economic reforms are necessary immediately, not only to create conditions for growth but also to deprive instigators of conflict of their economic power base. Activities such as institution and capacity building take many years, so they also should be started earlier rather than later.

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

While it is clear that economic governance in general should start immediately, that is not to say that all aspects should be begun immediately. Privatization, for example, needs to be considered in the context of what is being gained immediately and what its cost is in terms of the immediate welfare of the population. It may not be appropriate at the early stages of reconstruction, and the best strategy may be to postpone extensive privatization activity to a somewhat later stage. Though well-managed private firms with strong systems of corporate governance function more efficiently and better create jobs and serve consumers than poorly run, state-owned firms, a successful privatization effort requires resources and an environment of sound overall economic conditions that may not exist immediately following conflict.

ECONOMIC POLICY ENVIRONMENT

Too little attention has been paid during reconstruction efforts to building up statistical bases so that government officials and donors can understand the postconflict economic environment. The first component in a sound monetary policymaking process, for example, is good data: without good data, it is impossible to know what is happening with monetary aggregates or what the inflation rate is, let alone target it. This is important because inflation policy in many postconflict countries seeks to bring inflation rates down—from hyperinflationary levels to a level conducive to economic growth over a very short period of time. It is important to not overshoot. Most postconflict countries are also undergoing considerable structural reforms, requiring numerous adjustments in relative prices. Because nominal prices exhibit downward stickiness, a low level of inflation is important for easing these relative price adjustments. Postconflict countries should aim for inflation rates of 5–10 percent.

Using a foreign country's currency can avoid hyperinflation, but it is tantamount to a fixed exchange rate, and the country gives up its capacity to manage its own price policy. Notwithstanding, policymakers must keep monetary and exchange-rate issues in mind. If donor grants lead to the equivalent of currency appreciation and make domestic labor and exports uncompetitive, policymakers may need to sterilize the macroeconomic impact by maintaining any budget surpluses or other available funds overseas.

Physically introducing a new currency (or a borrowed currency) in a wartorn country is an enormous logistical undertaking, requiring coordination, planning, a massive public relations campaign, and secure delivery of cash simultaneously around the country. 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 also need to be made about who can participate in currency auctions.

> **"There are no shortcuts to job creation, other than creating favorable conditions for the private sector to grow."**

In a postconflict country with its own new currency, a flexible exchange-rate regime usually makes the most sense. The central bank likely has depleted reserves and no capacity to maintain a fixed exchange rate, though some intervention will be necessary to counter large flows of donor and other resources into and out of the country. In particular, if a country needs to undergo significant structural reforms and adjustments in relative prices, a slightly higher inflation rate (relative to the dollar or the rate found in the Eurozone) might be desirable, since too low an inflation rate impedes relative price adjustment.

Economies in postconflict countries also need a rudimentary banking system that provides payment services and mediates between savers and investors. Rules must ensure transparency and prevent government direction of lending. Other financial market institutions can wait until later stages of development. If sophisticated institutions are needed, foreign institutions (or foreign experts) can be invited to play a role.

JOB CREATION

Job creation is also important. Donors can have a negative impact on private-sector job creation, as their own organizations begin to dominate the labor market for professionally skilled workers. There are no shortcuts to job creation other than creating favorable conditions for the private sector to grow, particularly with low taxes and social contributions on labor.

The removal of administrative and other barriers to small enterprise creation can also facilitate rapid growth of a labor-intensive small and medium enterprise sector. In postconflict economies, indirect taxes on consumption are better than direct taxes on profits and incomes, which cause more distortions. In particular, taxes and social contributions on labor should be avoided. Such taxes reduce employment by increasing labor costs, and employment generation is always a principal concern.

INSTITUTIONS AND LAWS

Institutions need to be built to address specific trade issues and create foreign demand for domestic production, the spark that ignites development. Open trade relations can provide the initial demand to start a virtuous circle of economic activity that pulls a wartorn country out of economic collapse. This can be a particular challenge if the postconflict area is not a sovereign country with clear rights to participate in trade negotiations, if it faces continued hostility from neighbors due to past ethnic and political conflicts, and if its trade negotiating capacity is limited.

The task of creating new institutions and organizing ministries, central banks, and statistical offices usually takes far greater time and resources than expected. Often, insufficient resources are allocated to building capacity of national policymakers as well as training officials in central banks and ministries of finance in modern economics, since high-level officials are usually ousted in postconflict situations. If general education levels are low and new staff must be found for new government offices, the allocation of limited resources to professional training and education will undermine development progress and future prospects.

Some countries can revert to preexisting institutions, but others must create new ones. Basic commercial laws and institutions are needed to jumpstart private-sector development, encourage foreign direct investment, and quickly create a competition policy that ensures an open, level playing field that allows individuals and firms have opportunities to operate and compete under market conditions.

General laws and regulations are needed that allow for registration of firms (individually owned, partnerships, and corporations—both domestic and foreign). Private property needs to be protected. Contracts need to be enforced. Legislation is also needed to enforce pledges and loans (eventually including mortgages).

Bankruptcy law needs to govern the reorganization and liquidation of companies. Privatization law and competition policies are also needed, particularly where ownership has been highly concentrated or held by the state. Regulatory environments often need to be created or reformed for particular sectors, such as telecommunications, infrastructure, and oil and gas.

Though a cookie-cutter approach—where pieces of legislation are copied wholesale into a country—is the only way to quickly create a modern legal basis from scratch, it has obvious drawbacks. The new legislation will not be entirely consistent with existing laws, nor will it even be understood by legislators, courts, and other practitioners. On the other hand, carefully adapting each new law

“Privatization law and competition policies are also needed, particularly where ownership has been highly concentrated or held by the state.”

to particular circumstances will be a prohibitively long process. Each approach has its tradeoffs.

SOCIAL PROGRAMS

In postconflict countries, social policy must evolve into well-targeted, efficient programs for those most in need, either starting from scratch or reforming programs that have been poorly targeted or based on political privilege. Social programs are how a country provides for its most vulnerable groups, particularly during periods of economic restructuring and adjustment. Social programs also can serve an important political purpose, providing benefits to influential stakeholders. Postconflict countries that have had generous pension programs should move quickly to institute a modern pension system rather then backsliding into recreating the old system.

Gender and women’s issues are particularly important in postconflict situations. Under conflict regimes where the most brutal succeed, women tend to fare particularly poorly; in worst cases, rape is a military strategy and sex slavery is rampant. To varying degrees, reconstruction efforts have addressed gender issues by revising laws to grant rights to women or reserve a certain percentage of places in the legislative assemblies for them. Legal changes can also directly address women’s rights to own property and businesses and to receive bank loans.

SECTORAL POLICIES

Appropriate sectoral policies—an important complement to overall macroeconomic policy —should address needs in key sectors without creating distortions or picking winners. Given that the government's primary function is to set positive overall economic conditions, provide a level playing field, and let markets work, appropriate sectoral policies would address market failures, externalities, and the particular public institutions that may be necessary. In general, there is a much greater role for government in policies related to intermediary sectors, where most public goods are and the need for government intervention is greatest, compared to those sectors that produce final goods and services.

Agriculture, however, is a particularly important sector in many postconflict countries, as it employs poorer, but politically important elements of the population. The results of sectoral reforms, in land and other areas, in recent postconflict countries have been mixed. Usually, such complex, politically sensitive reforms have received insufficient attention from donors.

RECONSTRUCTION LESSONS

THE MARSHALL PLAN AND POSTWAR JAPAN

A speech by George C. Marshall on June 5, 1947, launched the Marshall Plan that rebuilt Europe.

Some of the growing literature on the Marshall Plan's applicability to current postwar reconstruction efforts focuses on technical issues and overlooks the plan's goals, organization, and funding mandate. Crucially, it was treated as an investment designed to benefit the United States, rather than a recovery exercise or the carrying out of a "moral obligation." The significant point in the success of post-World War II reconstruction was that the programs were well thought out and planned, at least after the first year of uncoordinated and unfocused assistance.

Donor competition was absent. Under U.S. authority, effective institutions for governing were created, and recurrent and capital expenditures were unified under one U.S. spending authority. Donor decisionmaking was also unified under one structure, led by the United States, with little more than opportunities for consultations by other donors.

That all assistance was under the auspices of the U.S. Government was not the main factor in the success of postwar reconstruction programs. What is of more interest is how the Truman administration, faced with division and squabbling between the State and War departments, worked to resolve issues, restore the advantage of a single-donor decisionmaking process, and honed the ability to self-correct. Entities engaged in postwar reconstruction availed themselves of all available U.S. Government resources on economic reconstruction and planning, and they were supported by secretariats that provided unified staff assistance. Planning and implementation of the Marshall Plan and the Japanese reconstruction program were thus well organized and coordinated, through a unified structure and an explicit national development framework.

More attention was given to broad humanitarian assistance and food security than to administratively more complex social assistance programs in Europe and Japan, but the focus was on economic governance issues as much as humanitarian, security, and physical reconstruction programs. Significant attention was given to budget execution, establishing a functioning fiscal authority and a rational tax system, and ensuring fiscal discipline within available tax revenues so as to not cause instability. As much as possible, the budget was used to guide policy, priority was given to rebuilding economies and institutions of economic governance, and the services of development agencies were available to help achieve collectively agreed-upon goals. The fiscally disciplined Erhard Plan is credited with establishing fiscal stability and, consequently, the monetary stability that laid the foundation for Germany's rapid growth and development.

U.S. occupation forces in Germany and Japan invested in developing a statistical base on the economy and statistical analyses to inform policymaking. The German economy was reformed and put on a fiscally prudent path, in sharp contrast to punitive policies adopted after World War I. Establishment of rudimentary clearing mechanisms was sequenced first, along with the restarting of production and fiscal and monetary stability. Full currency convertibility and extensive financial sector reform came later, and narrowly targeted institutions of cooperation were created before broader institutions. The establishment of convertible currencies between European countries was a central part of the Economic Recovery Act, though not immediately introduced.

In Europe, only 5 percent of U.S. assistance was reserved for U.S. spending needs; 95 percent was used for purposes deemed important by recipient states. In each European country, resources were allocated to the creation of means for effective budget execution, including local-country decisionmaking in procurements. Programs emphasized production and integration of countries into a continent-wide economy, and an intra-European payments system was created to facilitate intercountry trade. The success of the Marshall Plan was built on the principle of encouraging trade among European countries and with the United States. Policymakers were particularly keen to ensure openness of European borders and to build institutions necessary for promoting European regional trade and integration. These efforts to promote development through trade integration subsequently evolved into the European Community and European Union, the most successful example of economic development in the twentieth century.


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Occupiers fundamentally revamped the eduction system and improved the status of women in postwar Japan.

"U.S. occupation forces invested in developing a statistical base on the economy and statistical analyses to inform policymaking."

In postwar Japan, occupation reform efforts reduced concentration of ownership in large firms that had been in the hands of militarists. The occupiers quickly introduced modern commercial laws, thereby putting Japan on the path to market development. They also fundamentally revamped the education system, a massive undertaking guided by a large commission of U.S. education leaders. Modern competition policy was introduced, and various anticompetitive and monopolistic practices were made illegal. The relatively open, competitive environment created gave other social groups a stake in the newly restructured economy, and there was no widespread purge of government bureaucracies.

Vast amounts of legislation were copied and adopted as Japanese law from various international best practices, giving Japan a cut-and-paste modern legal system. One crucial component was the addition of a constitutional article that guaranteed women's rights, marking a fundamental turnaround in the status of women in Japan. Land reform was another important element of the Allied Forces' agenda. Reforms that greatly increased ownership of land in agricultural regions by those working it contributed not only to Japan's economic productivity but also to widespread political support for the results of U.S. occupation.

OTHER RECONSTRUCTION EFFORTS: FROM BOSNIA TO AFGHANISTAN

BOSNIA IN 1995

Important gains were made initially in providing emergency assistance and helping Bosnia to return to normalcy after the Balkan Wars. But the reconstruction effort unfolded on an ad hoc basis: some planning was done by individual donors, but was not well coordinated with other donors. USAID's coherent plan of programs for Bosnia was only partially followed. With time, the prospects for sustained growth have become even more limited.

The country has only partially moved from socialist- to market-oriented laws, and it has failed to implement tax reform, mostly continuing high payroll taxes. Bosnia also largely recreated the old system of social benefits, based more on previous job status than actual social need. It attempted to reinstitute the 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.

Bosnia adopted its own currency, fixed at first to the deutschmark and then to the euro, using a currency board—an exception to the rule for monetary policy in postconflict countries. Such a board likely works only in a relatively small country, where comparatively large donor inflows could be expected to prevent pressure from mounting against a fixed exchange rate.

In Bosnia and the rest of the Balkans, security has only come with partition of people into mostly ethnically separate areas and a continued international presence dedicated to maintaining security. Another security issue is the organized crime groups associated with the Milosevic regime, which circumvented sanctions and facilitated transport of smuggled goods (particularly cigarettes) into Europe. Many of these groups have continued to operate, expanding into new areas such as human trafficking. In other parts of former Yugoslavia, their activities raise funds for radical groups opposed to the peace process.

Very little progress has been made in creating a unified state and common economic space. Instead, a system of parallel governments—one international and one local—was established, and the local government was broken into cantons split along ethnic lines. While this cumbersome form of government was perhaps unavoidable, it has been largely ineffectual and an impediment to most development efforts. The parallel structure also reduces the pressure on local authorities to act responsibly in their decisionmaking.

KOSOVO IN 1998–99

An economic governance package that had been reasonably well planned in advance was introduced early on in Kosovo after the NATO bombing campaign. Much of the legal and institutional foundation for a market economy was built, most of it unprecedented, including new economic governance institutions that included a central bank and private commercial banks. Legislation was enacted on company law, contracts, pledges, procurement, and a host of other areas.

A modern tax system was established that emphasized indirect rather than labor-based taxes, starting with simple presumptive taxes on total revenues and then moving to a VAT and low excise taxes. Taxes on labor have been kept low, initially with a 10 percent personal income tax rate and a small contribution for funded individual retirement accounts.

Kosovo also created a modern pension system, along with social programs that give needs-based assistance to the very poorest and a veterans' benefit. Based on objective poverty criteria that are relatively easy to measure for a government with limited administrative capacity, the program has been a useful mechanism for quelling opposition and giving a politically influential group a benefit from the postconflict system.

There has been less progress in other areas. Inadequate macroeconomic management and failure to open regional trade opportunities has resulted in poor performance of the domestic economy, and unchecked crime has exacerbated the situation.

The replacement of Serbian government officials by Albanians with no government experience has been another postconflict problem. While the training of officials in the treasury, tax administration, and various regulatory agencies has gone fairly well, Kosovo lacks macroeconomic and fiscal analysts within the Ministry of Finance or the central bank. Because the statistics office was unable to produce quality statistics needed for the policymaking process, the Ministry of Finance began to conduct its own ad hoc statistical analyses to construct the consumer price index and national accounts. Only in late 2003 and early 2004 did donor attention turn to assisting this office to develop statistics needed for a government in a modern market economy.

Kosovo's status—still part of a sovereign Serbia and Montenegro, but under an indefinite UN interim protectorate—has created great uncertainly, and there is no broad consensus on its final status. Trade barriers existed because neighboring countries did not recognize Kosovo license plates, car insurance, or any rules of origin. In addition, no authority consistently and adequately represented Kosovo within the Stability Pact for South Eastern Europe. Failure to develop better trade relations, 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. Its uncertain status also affects the future of property rights and investors' willingness to invest. The bifurcated system of government has often resulted in bad expenditure decisions.

"Trade barriers existed because neighboring countries did not recognize Kosovo license plates, car insurance, or any rules of origin."

The donor presence was organized under one roof of the UN mission, but each major donor has had its own pillar, whether humanitarian assistance and resettlement, civil affairs, democratic development, or economic development. Each maintained the culture of its donor organization, with some of them run by staff lacking relevant technical skills and experience. As in Bosnia, there was very little coordination between donors on capital expenditures and investment projects.

AfERdita Nimani, USAID

Private commercial banks were among economic governance institutions introduced into Kosovo.

EAST TIMOR IN 2000

In East Timor, the extent of preparedness benefited from the lessons of Bosnia and Kosovo. Toward the end of the conflict, representatives of the UN and the World Bank planned the reconstruction effort, with the participation of a number of East Timorese nationals in exile. The UN mission was better integrated into one organization than was the case in Kosovo, and more thought was given to creating an East Timorese government. Reconstruction has been a cooperative effort of many multinational donors, and their funding for capital projects was channeled through one account. However, the international community was unprepared for the level of destruction that followed the independence referendum, and in-country donor presence was less than what was required.

The public administration in East Timor was downsized at the outset of reconstruction. Since many Indonesian civil service employees had fled, positions were eliminated and East Timorese hired into a greatly reduced civil service. The greatly reduced level of expenditure did not unduly affect the quality of government services, facilitated a long-term fiscal envelope more compatible with a market economy, and created the foundation for a sustainable fiscal policy. It is likely that this bold reform would have been politically impossible at a later stage of the reconstruction process.

USAID

In Sierra Leone, donors focused initially on immediate tasks, including security and the reintegration of fighters into communities.

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 central payments office was mandated that would evolve into a central bank. Low tax rates conducive to economic growth yielded sufficient revenues to cover a portion of state expenditures. Until projected oil revenues come on stream, budget deficits are covered by World Bank-managed donor trust funds. These factors, along with community-based reconstruction and a significant international presence, contributed to the relative economic development East Timor experienced during the immediate postconflict period.

SIERRA LEONE AFTER 2000

In Sierra Leone after its civil war, assistance focused on bringing the diamond trade into the formal sector and out of the shadows where it provides financial resources to warring parties.

The UN mandate was drawn much more narrowly than in Kosovo and East Timor. Donors focused initially on immediate tasks: security, 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. The risk is that important structural reforms will be less politically feasible at a later stage.

Without concentrating on the broader development of economic governance capacity, fiscal policy focused on increasing revenues, shifting toward indirect taxation, maintaining a flexible exchange rate, keeping inflation in single digits, and building a medium-term expenditure framework on the budget preparation side. In retrospect, perhaps budget implementation should also have received attention early on.

Efforts to bring the diamond trade within state control have yielded some successes. More and more diamond traders are being formally licensed by the government and their activities monitored. These efforts have increased the benefit to the state budget from diamond revenues and reduced the extent to which conflict diamonds are funding arms purchases.

AFGHANISTAN AFTER OCTOBER 2001

With USAID support, steps have been taken toward physical reconstruction and the adoption of a market-oriented development agenda in Afghanistan. A legitimate government was quickly established after the invasion. Donors coordinated aid and capital investments through one account and one donor coordinating committee, and multidonor joint assessments were instituted at the outset of reconstruction activities. However, the limited progress in building a centralized system of state expenditures parallels the national government's limited political authority. That said, Afghanistan, in relative terms, is one of the more successful reconstruction efforts, largely because government and donor spending has strictly adhered to priorities in the country's National Development Framework and the budget has been used as the main tool of policy.

Since the end of the military campaign, Afghanistan has managed strong real growth. It has set in place a fiscal authority that can account for all donor funds used, and it has put a financial management information system in place for proper cash management of the government budget. This is a remarkable achievement among wartorn economies. The current and capital budget were fused early on in the process, a lesson from experiences in Kosovo. In addition, the introduction of a currency auction and new currency was well managed and an independent central bank was set up.

Among the country's notable problems is a weak security system outside the capital, which is a continuing and central impediment to growth. Opium production has risen since the conflict ended, and lower ministerial levels in the government continue to be staffed by personnel with low education levels. 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. During the initial postconflict years, the central bank was unable to target inflation without a reliable consumer price index. Only after a rudimentary index (at least for Kabul) was established could the bank begin targeting inflation rates, rather than the exchange rate.

Notwithstanding, Afghanistan has made good choices, often with the help of foreign assistance, in establishing the economic gover-

AP/World Wide Photos

Afghanistan adopted new currency in January 2003.

nance necessary for reconstruction. As in East Timor, progress has been made in centralizing most capital expenditures through one account overseen by the World Bank. Legal, regulatory, and trade policy reforms are being tackled. If the comprehensive set of economic governance reforms introduced are managed well, this should facilitate increased foreign assistance over the next 10 years.

But Afghanistan requires public-sector investment, particularly infrastructure reconstruction—funded by the United States and other donors and private investment—to ensure that the country can attract increased amounts of foreign aid in the out years and take advantage of economic reconstruction investment applied to date. But it is worth noting, within this context, that the level of assistance received is low, compared to other postconflict regimes, and that donor assistance must rise substantially to meet projected revenue requirements over the next seven years. Though security and transportation exceeded required donor assistance, none of other sectors even came close to meeting donor commitments of required resources.

IRAQ AFTER MARCH 2003

The reconstruction of Iraq is one of the largest postconflict efforts undertaken by the United States since the Marshall Plan. After the U.S.-led invasion and occupation, the Coalition Provisional Authority (CPA) put in place several important components of economic governance, including introducing and managing a new currency, building a modern budget preparation and execution process, and 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—were introduced. However, the legal and regulatory regime has lacked adequate local buy-in, the trade regime has not received adequate attention, Oil-for-Food (OFF) in-kind subsidies have not been monetized, and the privatization program has not been implemented.

The widespread postconflict destruction and looting was not anticipated. Although there was extensive planning for postwar reconstruction, much of it was not used. There was no national development framework as a working document for a new Iraqi regime, nor was there international buy-in from the world's major multilateral institutions.

The Department of Defense set much of the policy in the early months, and there were tensions between U.S. Government agencies involved in the reconstruction. Links and coordination between the CPA and Iraqi officials or counterparts have also been weak at times. The CPA did not use USAID resources as effectively as it could have, its initial focus was short term, and it did not undertake to self-correct, following the Marshall Plan example.

In addition, de-Baathification left many influential segments without a clear stake and removed many competent technocrats from government. Because there was no competent government-in-exile to assume the reins at the end of the conflict, a provisional solution—the CPA—was unavoidable. But this provisional presence caused lack of clear decisionmaking authority, another impediment to development.

Expectations also needed to be managed differently in Iraq than in poorer postconflict countries experiencing large refugee problems and humanitarian crises. Iraqis can remember when the country had the highest per capita income in the region and a diversified economy. In addition to its oil and gas wealth, Iraq has had a nationwide civil administration and human capital qualitatively on par with the rest of the Middle East.

Iraq's unemployment rate currently stands at about 50 percent, largely a result of the atrophying GDP after the 2003 invasion and an extremely poor growth performance since the 1980s and the Iran-Iraq War. The capital-intensive oil sector cannot absorb large numbers of unemployed. While oil can lead growth, the non-oil sector requires an investment environment that stimulates labor-absorbing growth. This requires a proper investment climate, backed up by an appropriately liberal trade regime, stable monetary policy, and a solid fiscal revenue and expenditure base—in other words, the proper economic governance institutions in place.

The CPA introduced some basic institutions: primarily the fiscal and monetary authorities of the Ministry of Finance and Iraq's central bank. Emphasizing monetary stability, the CPA instituted a currency auction, after much advocacy by USAID and the Bank of England.

To sterilize new donor flows and stabilize the existing currency, the CPA also launched a new currency, drawing on IMF and USAID experiences in Afghanistan. Though much attention was given to improving banking capacity, difficult conditions slowed progress. When reconstruction began, most banks did not even communicate electronically with their own branches. The CPA decision to allow only large commercial banks and not small money changers had a political rationale, but it greatly limited the number of participants in auctions, made collusion and manipulation of market exchange rates easier, and effectively criminalized segments of the foreign exchange markets.

The CPA began a budget program that integrated all public revenues and expenditures; established a municipal, regional, and national framework and a financial management information system; began to tackle tax administration and capacity building in administration; and introduced personal and corporate taxes at low 15 percent maximum marginal rates. The authority also combined current and capital budgets, avoiding the mistake made in Kosovo and learning from Afghanistan. However, expenditures of the government of Iraq, the CPA, and OFF programs have not been fully integrated into a unified expenditure system, and the budget policies introduced, begun too late, may not be continued by the new Iraqi regime.

Two other problem areas are the legal and regulatory regime and trade. Though a full complement of commercial legislation was introduced by the CPA, most laws were imported, and they were issued without appropriate consultation and any relationship to Iraqi traditions, legal culture, or judicial review. Imported model laws are only a starting point of an iterative process; for the legal and regulatory environment to take hold, substantial domestic buy-in, implementing instructions, and precedent are required. Introducing a trade regime is more straightforward, but nothing has been implemented in Iraq, other than the lowering of tariff rates and the establishment of a trade bank.

The security situation in many parts of Iraq is the most significant factor impeding economic growth. Another factor is OFF programs, which created a dependence on subsidized imported food that was distributed almost free to domestic markets. OFF-subsidized imports distorted the economy—reducing domestic production and impeding job creation—and created opportunities for corruption by giving government officials and distributors unusual power over the allocation of the economy's resources. Together with the security situation, the failure to replace OFF programs with monetary subsidies during the brief period of coalition rule might turn out to be a key shortcoming of the reconstruction effort, since this task is more unlikely to be undertaken by subsequent governments with a more tenuous grip on power.

LESSONS IN ECONOMIC GOVERNANCE

1–13: GENERAL LESSONS

These general lessons address the principles of preparedness and planning beforehand; the rational structuring of government and donor assistance; a focus on private-sector–led growth; the economic reform agenda predating the conflict; resolution of final political status; programs for key political and social constituencies; and capacity building.

1. Begin to plan early: Preparation should begin early, while the conflict is still underway, and potential donors and representatives of any national organizations likely to play a role in the postconflict government should participate. The tasks of organizing donors, preparing to move funds, identifying key issues and counterparts, and getting personnel ready to relocate require at least several months, even with concerted effort.

2. Offer well-thought-out and logical donor assistance: New, postconflict governments and donor presence should be well integrated and structured to address their tasks; they should not merely reflect underlying political tensions and donor cultures.

3. Focus on private-sector–led growth: Even at the initial reconstruction stage, growth and job creation should be expected to come from private-sector–led growth, not government and donor spending.

4. Give security a high priority: Security is a public good that the government (with international support) mostly needs to provide, and it is essential for reconstruction, investment, and economic development. But is wrong to think that security must precede economic development. Both must come together, synchronically, and lack of progress with one will hinder the other.

5. Fight crime: Postconflict programs must focus on preventing organized (and unorganized) crime from corrupting the democratization process or impairing the general environment for business and foreign investors.

6. Address the economic reform agenda predating the conflict: Unless the underlying economic problems that originally contributed to conflict are addressed, they can continue to cause instability and threaten the peace.

7. Work toward resolution of final political status: Lack of resolution of final political status creates uncertainty and impedes reconstruction, investment, and economic growth. To the extent possible, assistance efforts need to recognize the importance of building certainty into reconstruction processes.

8. Develop programs for key political and social constituencies: Early programs need to focus on key political and social constituencies, including social programs that help most vulnerable population groups and give veterans and decommissioned soldiers a stake in the new society.

9. Build new institutions for economic governance: Building new institutions for economic governance takes time, and it should begin early in the reconstruction process.

10. Train individuals for economic governance: The training of a professional class of analysts and policymakers for economic governance also takes time, and should begin early in the reconstruction process.

11. Develop sound economic data: A modern policymaking process needs sound economic data, which require considerable investments by donors to develop.

12. Pay attention to sequencing: High-priority and time-consuming activities should begin toward the start of the reconstruction effort. These high-priority activities include actions to assure security, budget execution systems, and capacity building. Fiscal, monetary, and financial reform are always necessary—early and often. Privatization does not have the same urgency.

13. Undertake difficult reforms when reconstruction is just beginning: The period at the very start of reconstruction, while often chaotic, is an important window of opportunity to undertake politically difficult reforms and institutional changes. Then the level of influence of donors is particularly high and the level of power and organization of opponents of reform is particularly low. Donors may be able to undertake fundamental reforms that are not possible at other times.

14–26: PILLARS OF SOUND ECONOMIC GOVERNANCE

The lessons listed concern the six pillars of sound economic governance: macroeconomic and financial stability; balanced and efficient fiscal policy; open trade relations; robust legal and regulatory regimes; equitable social policy; and appropriate sectoral policies.

14. Focus on macroeconomic and financial stability: Prior to setting monetary and exchange policy, instruments for setting and implementing policy should be created: a currency in circulation, a foreign exchange market, market data on prices and exchange rates, and a policymaking process in an independent central bank or its equivalent.

15. Pay attention to exchange-rate and inflation policy: The need for stability must be balanced with the need for export competitiveness. Careful responses are needed to neutralize the impact of large donor inflows and other postconflict macroeconomic phenomena.

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

17. Start with the basics in the financial sector: Financial sector policies should concentrate on the basics of creating a payments system and establishing a rudimentary regulatory regime over a private banking industry. The cultivation of more sophisticated financial market institutions should be left to a later stage in development.

18. Develop balanced and efficient fiscal policies: One of the most immediate tasks in postconflict country is the creation of mechanisms for budget execution. Creating or improving systems of budget execution is the first priority for expenditure policy, even before developing a budget preparation process. A government (or donor surrogate) needs a modern treasury system and expenditure information management system through which all expenditures can be implemented and monitored.

*19. Begin tax policy with simple, indirect taxes:*Tax policy should evolve, along with the capacity of tax administration. It should begin with simple, indirect taxes such as presumptive taxes, and develop toward more complex, indirect taxes, such as the value-added tax.

20. Integrate capital expenditures and investment projects: Capital expenditures and investment projects should be integrated into a comprehensive state public investment program and capital budget.

21. Open trade relations: Institutions need to be built to address each country's specific trade issues and create foreign demand for domestic production, which can be the spark that ignites development.

22. Establish robust legal and regulatory regimes: Basic commercial laws and institutions—including laws and regulations that allow for registration of firms, govern bankruptcy, protect private property, and enforce contracts—are necessary for jumpstarting private-sector development and encouraging foreign direct investment. Privatization law and competition policies may be needed, along with relevant regulatory environments for particular sectors.

23. Establish equitable social policies: Social policies must evolve into well-targeted efficient programs for those most in need, along with those that serve important political purposes, including providing benefits to influential stakeholders such as war veterans.

24. Institute a modern pension system: Countries that had generous pension programs should move quickly to institute a modern pension system.

25. Address gender discrimination and women's issues: The use of rape as a military strategy, sex slavery, and trafficking in women and children may need to be addressed, along with legal changes that recognize women's rights to own property and businesses and receive bank loans.

26. Promote appropriate sectoral policies: Appropriate sectoral policies should provide public goods where needed, particularly in infrastructure areas. Such policies address market failures, externalities, and the need for public institutions particular to various sectors, but without creating distortions or "picking winners."

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