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CHAPTER FIVE

Aid and Fiscal Capacity Building in Post-Conflict Countries

James K. Boyce

In attempting to support the transition from war to peace, the international community often provides substantial assistance. This aid can play an important role in meeting pressing social needs and building a durable peace, but it would be naïve to assume that positive outcomes are the automatic result of good intentions. An important dimension of the impact of aid in what are optimistically called 'post-conflict settings' is the extent to which it helps build the fiscal basis for a sustainable state – that is, governmental capacities to mobilise domestic revenue, allocate resources through the budget and manage public expenditure.

Sooner or later, however, the flow of aid will diminish and responsibility for ongoing public expenditures must be shouldered by the government. A crucial issue in post-war transitions is, therefore, the building of state capacities to collect taxes and to allocate and manage expenditure. All too often, however,

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members of the international community have regarded the building of fiscal capacities as a niche issue than can be left to the international financial institutions to address through technical assistance. This stance of benign neglect can have malign results.

'Dual public sector' or dual control? External support for domestic expenditure

Donors often channel a large share of their resources away from the state, relying upon external agencies and private contractors to carry out the work, a policy rationalised on the grounds that state institutions are incompetent or corrupt. The result is a 'dual public sector': an internal sector that is funded and managed by the government, and an external one funded and managed by the donors. In terms of the sheer amount of money, the latter frequently dwarfs the former.

Whatever its merits, the 'dual public sector' strategy has several adverse consequences: firstly, and most evident, is the failure to tap external assistance to build the state's own fiscal capacities. Secondly, and no less seriously, is the 'crowding-out' effect as professionals are recruited into the external public sector, often for salaries that the government cannot match. Ironically, aid donors then point to a lack of capable government personnel as a rationale for continuing to bypass the state. Thirdly, the fact that the external public sector is managed by numerous agencies, each with its own priorities, poses enormous coordination problems. Last but not least, there are no institutional mechanisms that make donor agencies accountable to the local citizenry. No matter how imperfect the degree of democratic governance, the state arguably has a comparative advantage in this respect.

Donors maintain that they (and the non-governmental organisations and private contractors on whom they often rely) do a more effective job than the government in delivering goods and services. Undoubtedly there are situations in which the short-term advantages make a compelling case for circumventing the state, as when the government is incapable of meeting immediate humanitarian needs. But once we recognise that the long-term aim of aid is – or ought to be – to build state capacities as well as to deliver services in the short run, the argument for the dual public sector loses at least some of its force. Moreover, experience shows that the 'short run' invoked by donors can last a long time. In Cambodia, where more than a decade has elapsed since the United Nations transitional administration handed power to a new government, the donors' focus on delivering results still leads them to 'bypass when possible – and capture when not – the Cambodian civil service,' and that spending on technical assistance remains two to three times greater than the total wages paid to government civil servants.[1]

Concerns about corruption in the internal public sector are often a significant impediment to channelling more external assistance *through* the state. Corruption saps the delivery of public services, deters private investment and fuels popular discontent. But not all corruption is equal, nor is it equally corrosive: in some cases it is driven entirely by individual greed, but in others it provides patronage resources for wider networks. An example of the latter is the use of government revenues and profits from state-sanctioned monopolies to lubricate neopatrimonial governance in the Palestinian Authority.

Donors often adopt an avoidance strategy towards corruption: they seek to avoid aid 'leakages' by bypassing the government and they seek to avoid public discussion of the topic for fear of ruffling political feathers. This strategy is dysfunctional in three respects. Firstly, aid that is routed outside the government is insulated from neither the perception nor the reality of corruption. Indeed, the lack of transparency and accountability mechanisms can fuel public perceptions that externally administered projects are even more prone to corruption than government projects. Secondly, the avoidance strategy fails to harness aid to build state capacity to budget and manage public expenditure effectively. Thirdly, it sends an unmistakable signal to the populace: the government cannot be trusted. This has a negative feedback effect on domestic revenue mobilisation, insofar as the willingness to pay taxes hinges on perceptions that the state will deliver services in return.

An alternative strategy for addressing problems of corruption would have two prongs. The first is to devise transitional assistance programmes for people who have been dependent on patronage networks, recognising that corruption for such 'neopatrimonial' purposes differs from personal corruption. Such assistance would be analogous, in a sense, to job training programmes for workers displaced by the effects of trade liberalisation in industrialised countries, and to the disarmament, demobilisation, and reintegration (DDR) programmes for ex-combatants that are often implemented in post-war countries.

The second prong of an alternative anti-corruption strategy is the use of dual-control systems to build institutions for accountability and transparency alongside public expenditure capacities. The Afghanistan Reconstruction Trust Fund (ARTF), a World Bank-administered account through which donors help to fund government expenditures for salaries and other non-investment items, offers an instructive model for how aid can be rerouted through the government – in effect, helping to internalise external resources[2]. The Afghan government allocates these external resources through its internal budgetary process, reinforcing the budget as the central instrument of policy. When the ministries spend the money – for example, in paying teachers – an external monitoring agent appointed by the World Bank verifies that the accounting standards of the ARTF and government (which are the same) have been met, and releases the funds. In this way the ARTF is like a bank account with a fiduciary screen, similar to the dual-control arrangements established in Liberia under the Governance and Economic Management Assistance Programme (GEMAP).

Channelling aid through the government in this fashion does not imply that the donors abdicate control or responsibility for how their resources are used. Two signatures are required to release funds: one from the government and one from the external monitoring agent. The result is a dual-control system – a set-up analogous to the dual-key system used to prevent an accidental launch of nuclear missiles.

Priming the pump? External support for domestic revenue mobilisation

In many post-war settings, a central task is to raise domestic revenue to provide sustainable funding for new democratic institutions and for expenditures to improve well-being, strengthen public security and ease social tensions. Typically, the amount of government revenue relative to gross domestic product in war-torn societies is far below the average for other countries with similar per capita income.[3] Yet the needs for government expenditure are, if anything, greater. Hence concerted efforts are needed to increase revenues.

Experience has shown that aid can 'crowd out' domestic revenue mobilisation, reducing the incentive for the government to tax its own populace. The international community can support government efforts to mobilise domestic revenue in four ways: (a) by providing technical assistance; (b) by linking some of its aid to progress in domestic revenue performance; (c) by helping to curb taxation by non-state actors (sometimes called warlords); and (d) by reducing tax exemptions on post-war aid.

Technical assistance (TA) is the most common type of support. The IMF, World Bank and bilateral donors have helped to develop revenue capacities, ranging from drafting tax codes to setting up special tax administration units within finance ministries and providing special training and higher pay in an effort to insulate them from corruption.

In some cases, TA providers have shown an impressive ability to cast aside orthodoxies and adapt their policy advice to local realities. For example, despite the aversion of the IFIs to trade taxes, import duties were recognised as the most feasible source of revenue enhancement in Afghanistan, Kosovo and Timor Leste. In the case of Timor Leste, the IMF even supported the introduction of a levy on coffee exports.

The effectiveness of TA could be further strengthened by efforts to adopt technologies and procedures that build on existing capacities, rather than opting for off-the-shelf imported solutions. In Afghanistan, for example, former finance minister Ashraf Ghani, in his 2007 book *Fixing Failed States*, recalls that computerised information systems introduced at the Ministry of Finance were 'unsuitable in terms of complexity and language', prompting subsequent efforts to retool with Persian-language systems from Iran. More attention to training local personnel could also foster capacity building. Emilia Pires and Michael Francino, who served as planning secretary and cabinet member for finance in Timor Leste's transitional government, remark that the concentration on expatriate advisory services in Timor Leste was accompanied by 'some neglect for formal training programs for national staff'.[4] Put another way, the donors in this case appeared to be overlooking the ultimate goal of technical assistance: to make themselves eventually redundant.

Conditionality is a second way that donors can encourage domestic resource mobilisation. On the expenditure side of fiscal policy, it is not unusual for donors to require counterpart funding from the government as a condition for providing aid to specific projects, a strategy intended to ensure domestic 'ownership' and to counteract fungibility (whereby aid merely frees government money for other uses). It would be a straightforward matter to link certain types of aid – notably budget support – to progress in meeting domestic revenue targets. Such a policy is akin to the provision of matching grants by private foundations. In both cases, the aim is to strengthen incentives for aid recipients to seek further resources, counteracting the disincentivising effects of unconditional aid.

Visiting Guatemala in May 1997, a few months after the signing of that country's peace accords, IMF Managing Director Michel Camdessus took a step in this direction when he said that the Fund's only condition for a stand-by agreement would be that the government complied with its peace-accord commitments, including a 50% increase in the revenue-to-GDP ratio.[5] Similarly, the European Union conditioned its budget support for the government of Mozambique in 2002 on increases in domestic revenue.[6] And one of the benchmarks in the Afghanistan Compact signed in London in early 2006, which sets out the framework for international assistance to that country over the next five years, was to increase the revenue from 4.5% of GDP in 2004/05 to 8% in 2010/11.[7] These examples of efforts to link aid to domestic revenue performance remain the exception, however, rather than the rule.[8]

Curbing taxation by non-state actors is a task located on the cusp between public finance and security. When profits from the exploitation of nominally public resources – for example, Cambodia's forests or African minerals – flow into private pockets, this not only deprives the state of revenues but also often finances quasi-autonomous armed groups that threaten the peace. When local warlords levy 'taxes' on trade, sometimes including trade in narcotics, as in Afghanistan, they undermine the state's monopoly not only on revenue collection but also on the legitimate exercise of force. Curtailing such activities may require international assistance. Yet peacekeeping forces, even those with a relatively expansive mandate like the International Security Assistance Force (ISAF) in Afghanistan, typically have not seen this as a part of their job.

Powerful members of the international community may be reluctant to crack down on extra-legal revenue exactions when they regard those involved as political allies. In Afghanistan, for example, efforts to consolidate revenue in the hands of the state and to fight drug trafficking have been complicated – to put it lightly – by the decision of the United States government to enlist anti-Taliban warlords as partners in its 'global war on terror'. Such marriages of convenience, reminiscent of US support to the anti-Soviet mujahadeen in the 1980s, may serve short-term security objectives, but in the long term they undermine the legitimacy and effectiveness of the state – and ultimately security.

Reducing tax exemptions on post-war aid flows could do much to prime the pump of domestic revenue-collection capacity. In the first post-war years, aid often is the single biggest component of the formal-sector economy. Yet today aid flows, and many of the incomes generated by them, are tax-exempt. The incomes of expatriate aid officials and aid workers are often tax-free. The incomes of their local staff, often quite high by local standards, tend to enjoy similar status. Goods imported by the aid agencies, ranging from Toyota land cruisers to cases of Coca-Cola and whiskey, and rents paid by expatriates for office space and housing – again, often exorbitant by local standards – may also be tax-free. So are other services provided to them, such as hotel accommodation and restaurants.

These pervasive exemptions have several adverse consequences. Most obvious are the forgone government revenues. In addition, scarce administrative capacity is devoted to administering different rules for different people. Goods that enter the country as aid may wind up on sale in local markets, undercutting legitimate competitors who pay import duties. Last but not least, the special treatment accorded to expatriates again sends an unmistakable message to the local populace: rich and powerful people do not have to pay taxes. The result can be 'the creation of a culture of tax exemptions', in the words of a recent IMF review of post-conflict experiences.[9] This runs precisely counter to efforts to establish effective and progressive revenue collection systems and undermines the credibility of international agencies when they argue that governments should reduce tax loopholes and tax incentives for local businesses.

Efforts to tax aid bonanzas have met with determined resistance from donors. In Timor Leste, efforts to tax the floating hotels in the Dili harbour that accommodated the post-war influx of foreigners were rebuffed by lawyers at United Nations headquarters in New York, on the dubious grounds that diplomatic 'privileges and immunities' extend to those who provide services to UN personnel. In Afghanistan, the introduction of a tax on rental incomes generated by expatriates in Kabul likewise met resistance; as Ghani remarks: 'the international community's declarations on the importance of enhancing domestic revenue mobilisation have not been matched by willingness to consider new initiatives to tap the revenue possibilities generated by their own presence.'[10] This issue has often pitted the IMF and World Bank, along with national officials, against other donor agencies. In Timor

Leste, Pires and Francino recall ‘bitter fights between international officials at the Ministry of Finance and international officials of donor organizations … with the latter winning’.[11] Similarly, non-governmental organisations (NGOs) ‘ferociously defended every inch of ground’ in resisting taxation of even their local employees: ‘Even when UNTAET (the United Nations Transitional Administration in Timor Leste) offered to pay the taxes of international staff working with NGOs provided they were prepared to declare the income they were receiving, the answer was still “No”.’[12]

Donor officials argue that paying taxes amounts to budget support. While this is true, its implicit premise – that the government cannot be trusted to use tax revenues well – again sends a negative message to the local populace. Donors also argue that expatriates are already paying taxes in their countries of origin. In cases where this is so, existing tax treaties allow credits for taxes paid elsewhere, thereby avoiding the problem of double taxation. Income-tax payments by expatriate or local aid personnel would not need to come from their own pockets. Those who pay taxes could be given salary ‘top-ups’ to maintain their after-tax incomes. This is the current practice for US citizens employed by the United Nations, World Bank and IMF.

Initiatives to tap aid inflows for domestic revenue could also take the form of ‘payments in lieu of taxes’ (PILOTs), a solution that has been adopted in many college towns in the US where municipal governments want tax-exempt institutions of higher education to contribute to the funding of public services such as schools, police and fire protection. PILOTs maintain the legal privileges of the payee, while at the same time opening the door for those donors who are serious about building domestic revenue capacity to act without waiting for across-the-board solutions.

Fiscal policy through a conflict lens

Fiscal policymaking in post-war settings requires careful attention to priorities. Faced with many pressing needs – for spending in areas such as public safety, the demobilisation and reintegration of ex-combatants, health, education, and the rehabilitation of economic infrastructure – how should scarce resources be allocated?

The synthesis report emerging from the World Bank's multi-year research programme on violent conflict observes that the need to consider peacebuilding alongside economic imperatives 'creates the potential for trade-offs between policies that promote growth and those that promote peace'. For example, a strategy focused exclusively on short-term economic returns might concentrate spending on the capital city and developed regions, leading to 'a trade-off between the growth-maximising geographic distribution of public expenditure and a distribution that might be regarded as fair'. [13] Where such trade-offs exist, the report concludes, 'the government may need to give priority to policies for peacebuilding'.

When public expenditure is viewed through a conflict lens, it is impossible to separate the question of 'what' from that of 'to whom?'. As shown by researchers at the UK-based Institute of Development Studies, grievances rooted in distributional inequalities are often important drivers of conflict, but these inequalities themselves tend to worsen during conflict:

> The already poor often lose the few assets they have, and looting adds to the number of poor. In contrast, warlords and their followers accumulate assets, and so while the early years of peace may see quite rapid growth it can be very narrow in its benefits – unless policies are put in place to restore the productive assets and human capital of the poor.[14]

Two distributional issues are particularly relevant in public expenditure. The first is how to incorporate distributional concerns into spending decisions. The second is how to allocate expenditures across the political landscape so as to bolster incentives for the implementation of accords and the consolidation of peace. Conflict-impact assessments should address both sets of issues. These are analogous to environmental-impact assessments, first introduced in the 1970s, with the difference that here the concern is the social and political environment rather than the natural environment. Conflic-impact assessment aims to incorporate the 'negative externalities' of social tensions and violent conflict. International aid agencies increasingly recognise the need for these assessments as an input into policymaking and project appraisal, and some have begun to put this recognition into practice.[15] Yet efforts to incorporate distributional considerations into expenditure decisions in post-conflict countries are still at an early stage.

Information on vertical equity – the distribution of benefits across the poor-to-rich spectrum – is sometimes collected and sometimes used as an input into policymaking. In many cases, however, even such basic data are not available. The paucity of information is even more severe in the case of horizontal equity (distribution across regions and groups defined on the basis of race, ethnicity, language or religion). In the past decade, researchers have analysed the role of horizontal equity in the genesis of civil wars, and economists have begun to think hard about how to measure it.[16]

Collection of regional data on expenditures in administrative units, such as states, provinces and districts, would seem to be relatively straightforward, both practically (since ministries often allocate their funds across regional units) and politically (since regions can often serve as a proxy for more sensitive categories such as ethnicity). Yet today even such data are remarkably few and far between. Ashraf Ghani and his colleagues at the Institute for State Effectiveness recount their experience in Afghanistan:

> Obtaining the figures on provincial expenditures from line ministries required months of intense discussion and analysis of manual systems of recordings. When the figures were first presented to the Cabinet, it came as a shock that the ten poorest provinces of the country were receiving the smallest amounts of allocation.[17]

Some researchers have suggested that conflict is better understood as being driven by polarisation rather than inequality per se.[18] Polarisation refers to the interaction between alienation (across groups) and identification (within groups). Income polarisation, for example, is more extreme when the gap between rich and poor is wider (resulting in greater alienation between the two), and when income inequalities within the rich and within the poor are lower (resulting in greater identification with others in the same income group).

When economic polarisation (in the distribution of income, wealth, or other attributes such as employment, education, and health) aligns with social polarisation (the distribution of the population into identity groups based on race, ethnicity, language, religion or region), the potential for violent conflict may be multiplied. In a working paper written for the International Peace Academy in New York, Ravi Kanbur explains its effects:

> Polarisation of society into a small number of groups with distinct identities is an incubator of conflict on its own. But add to this the dimension of average income differences between the groups, and a combustible mix is created.[19]

This insight brings us back to the importance of horizontal inequality. The phenomena of between-group alienation and within-group identification have important implications for the role of 'social capital' in the dynamics of peacebuilding. Social capital – trust, norms, and networks that facilitate coordination and cooperation – is often regarded as wholesome and beneficial. But it can also have a dark side, insofar as it enables some groups to cooperate more effectively to the detriment of others. Drawing a distinction between 'bonding' social capital that promotes trust and cooperation within groups and 'bridging' social capital that promotes these between groups, As Robert Putnam acknowledges in his book *Bowling Alone: The Collapse and Revival of American Community*, 'some kinds of bonding capital may discourage the formation of bridging social capital and vice versa'.[20]

During civil wars, group identity can be expressed through violence ('bonding social capital') such as expropriation of property or businesses, pillaging, rape and murder. Meanwhile, bridging social capital is destroyed, with consequences that can be just as serious as losses of physical capital. In the Bosnian war, for example, the destruction of the medieval bridge at Mostar came to symbolise the breakdown of trust between Muslim Bosniaks and Catholic Bosnian Croats. During war-to-peace transitions, therefore, an important aim of public expenditure, and of public policies more generally, is not simply to build generic social capital but rather to build specifically those types of social capital that reduce inter-group alienation.

Cross-group associational ties cannot always be promoted in harmony with other goals of economic policy. One example of this is the potential for trade unions to serve as important arenas for cooperation across ethnic and religious cleavages; hence 'reducing the power of trade unions is an example of a policy that is often put forward in the name of increasing efficiency, but could have the long run result of increasing group tensions.'[21]

A further dimension of the 'who' question in post-war settings relates to balances of power among and within competing political parties and their supporters. This requires attention not only to community-wide characteristics such as living standards and ethnicity, but also to the stances of individual political leaders who often vary in their commitment to peace. Selective allocation of public spending can be one instrument with which to reward those who are committed to peace, penalise spoilers, and encourage the undecided to back peace implementation.

Distributional impacts need to be considered on the revenue side of fiscal policy, too. Inattention to 'who pays?' questions in revenue policy is dysfunctional for three reasons: firstly, because the conventional wisdom that distributional concerns should be addressed on the expenditure side of fiscal policy alone rests on a textbook 'optimal planner' model that does not fit reality; secondly, because even optimal planners would need full information on the distributional impacts of revenue policies to achieve their targets; and finally, because if the public believes that it matters how the tax burden is shared out, then politically it does.

Little has been done, however, to integrate distributional concerns into revenue policies in war-to-peace transitions. The primary revenue goal of post-war government authorities, and of the international agencies that seek to assist them, has been to increase the volume of collections; the secondary goal has been to do so as 'efficiently' as possible. To be sure, increasing the volume of revenue is a central task. And efficiency – if understood in terms of the realities of war-torn societies, as opposed to textbook axioms – is desirable. But neglect of the distributional impacts of taxation can subvert both of these goals.

The starting point for any effort to address this issue must be careful documentation of the distributional incidence of revenue instruments both vertically and horizontally. Collecting the necessary data will be a major task, for today there is a paucity of such information even in 'normal' developing countries, never mind in war-torn societies.[22] This can be contrasted with the situation in industrialised countries, where the distributional impacts of proposed taxes are typically subjected to intense scrutiny by politicians and policymakers alike. Ironically, it is precisely where the need for such analysis is greatest – in societies embarked on the fragile transition from war to peace – that these issues receive the least attention. Technical assistance from the international community could play a valuable role in filling this information gap.

Documentation is only the first step. The second is to incorporate this information into policymaking. In choosing the mix of revenue instruments – the balance between tariffs, value-added taxes and income taxes, for example – their distributional incidence must be considered alongside their revenue potential, administrative feasibility, and efficiency effects. One option that would be likely to receive much more attention is luxury taxation. Taxes on items such as private automobiles and private aircraft would be easy to administer and progressive in terms of distribution, and could raise substantial revenue. Remarkably, these rarely feature in discussions of post-war revenue policies.

Finally, information on the distributional impacts of revenue instruments, and on the ways that government policies are taking these into account, must be disseminated widely to the public, so as to generate trust and facilitate compliance. The importance of this was demonstrated vividly in Guatemala, where the peace accords set explicit targets for increasing government revenue and social expenditure. The first post-war government attempted to increase the tax on owners of large property. This effort was scuttled, however, in the face of protests not only from estate owners but also from indigenous smallholder farmers who thought that the tax would burden them.[23] The lesson is clear: successful revenue policymaking cannot be a purely technocratic preserve; it must be part and parcel of the democratic process.

Thinking about tomorrow, today: Getting serious about fiscal sustainability

External resources that are spent today often have implications for how domestic resources must be spent tomorrow. This is true both for recurrent expenditures, including salaries, and for capital expenditures that will require spending for operation and maintenance in future years. Hence there is an evident need to think about the long-term fiscal implications of current decisions.

In the aftermath of war, attention to pressing short-term needs is perfectly natural and valid. But this does not imply that the future consequences of today's decisions can or should be shunted aside for others to handle later. When building new government institutions and infrastructure, budget constraints must be borne in mind. It would be a mistake to rely on a transitory flush of external funds to create structures that are not fiscally sustainable. The point may seem obvious, but past experience suggests that it is often ignored.

Consider, for example, security spending in Afghanistan, where the Afghan National Army has been built with significant funding from the United States government. According to a World Bank report, security-sector expenditures in the three-year period from 2003/04 to 2005/06 were equivalent to nearly 500% of the Afghan government's revenue, or roughly a third of the country's GDP.[24] 'Total security expenditures will exceed forecast domestic revenues for some years to come,' warns the document, describing the situation as 'unaffordable and fiscally unsustainable'.[25] Even from a security standpoint, unsustainable expenditures are short-sighted. A well-equipped army that is not being paid ceases to be a security force; instead it becomes an insecurity force. A Global Monitoring Report prepared jointly by the United Nations Development Group and the World Bank in 2005 draws the clear lesson from such experiences: 'It is important to ensure that security issues are treated as an integral part of the national planning and budgetary process, rather than through separate forums which may lead to a lack of transparency or the taking of decisions which are fiscally unsustainable or undermine other reconstruction efforts.'[26]

Capital investments with high operation and maintenance costs also generate fiscal burdens further down the road. In Palestine, aid donors have often ignored the development plans of the Palestinian Authority (PA), 'undercutting any PA effort to monitor the cumulative long-term costs of donor-financed investments'.[27] Closely related to this problem is the bias of many aid-funded projects in favour of excessive reliance on imports. In deciding the extent to which the goods and services should be imported or procured locally, donors again face a trade-off between short-run expediency and long-run capacity building – the capacity in this case being in the private sector. There are undoubtedly cases where the former trumps the latter: for example, where local sourcing would require large investments with long gestation periods. But there are also cases where local procurement could do more to stimulate economic recovery, and perhaps save money in the process.[28]

To cite an example of the pervasive bias against local suppliers, during the United Nations Transitional Administration in Timor Leste, some 250,000 desks and chairs for local schools were purchased with money from the World Bank-administered Trust Fund for East Timor. At the time, some officials suggested that some of these be procured locally to spur the growth of small and medium woodworking enterprises, but this was rejected on the grounds that local procurement would be too slow.[29]

The interwoven challenges of building an effective state, a robust economy, and a durable peace all require thinking about tomorrow, today. Post-war inflows of external assistance cannot be sustained indefinitely. The success of aid ultimately rests on whether the structures built with it can be sustained without it.

Conclusion

A key statebuilding challenge in post-conflict countries is to build fiscal capacity (the state's ability to raise revenue, allocate resources, and manage expenditure to meet the needs and expectations of the population). These fiscal capacities do not arise by spontaneous generation. They must be developed with deliberation and care.

Well-designed international aid can assist in this vital task, but ill-designed aid can subvert it. When aid bypasses the state and creates a dual public sector – one funded by domestic resources and the other by external resources – a result can be the crowding out of state capacity to allocate resources and manage expenditure. When external resources act as a substitute for domestic resources, rather than serving as a complement to them, a result can be the crowding out of state capacity to raise revenue. When the distributional impacts of expenditure and revenue policies are ignored in favour of a single-minded focus on economic growth and efficiency, a result can be the exacerbation of social tensions that jeopardise the peace. When short-run targets swamp long-run needs, a result can be an unsustainable state and an unsustainable economy.

The obstacles to successful post-war reconstruction and peacebuilding are not only located within the war-torn societies themselves. They are also deeply rooted in the policies and priorities of the international community and donor agencies. Many business-as-usual practices – including the pursuit of commercial objectives, incentive structures that prioritise 'moving the money', and deficits in transparency, accountability and coordination – are ill-matched to the requirements of peacebuilding and state-building.[30] More effective aid for the reconstruction of war-torn societies will require the reconstruction of aid itself.