

5-1-2004

# The Fiscal Dimensions of Conflict and Reconstruction

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Accepted version. "The Fiscal Dimensions of Conflict and Reconstruction," in *Fiscal Policy for Development: Poverty, Reconstruction and Growth*. Eds. Tony Addison and Alan Roe. New York: Palgrave-Macmillan Publishing, 2004: 260-273.

The definitive, published, version of record is available here: [Publisher link](#).

# 12

## The Fiscal Dimensions of Conflict and Reconstruction\*

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### Introduction

Many developing countries have been affected by civil war either directly (e.g. Afghanistan, Angola, Côte d'Ivoire, Rwanda), as participants in the internal conflicts of other states (e.g. Rwanda and Uganda in the Democratic Republic of Congo, DRC), or as neighbours to countries in conflict (e.g. Tanzania and the Great Lakes region). Eritrea and Timor Leste won their independence after prolonged and intense struggle against authoritarian and colonial regimes. Inter-state wars have taken place in the developing world (most recently the 1998–2000 Eritrea war), but the majority of contemporary conflicts have been intra-state in character (although often with outside assistance to the internal belligerents). And many of these wars have occurred in low-income countries, including some of the world's very poorest societies.

Violent conflict is a complex phenomenon, and one with many causes and characteristics. The label 'post-conflict' is too often applied to societies that are far from achieving peace (notably Afghanistan and Liberia at present). There is now a wide-ranging debate on the causes of conflict and the tasks of post-conflict recovery, including conflict's economic dimensions. This is not to say that there is some mechanical relationship between economics and conflict and between economic policy and peace: complex non-economic factors such as ideologies and belief systems also play a role, as do the effectiveness of institutions in resolving conflict by non-violent means. But post-conflict strategies that fail to address the economic dimensions will certainly endanger otherwise promising political settlements.

Fiscal policy is one crucial economic dimension to conflict. Who gets what in the allocation of public spending and how it gets paid (the incidence of taxes) is one important influence on the level of political support for a government. If the distribution of spending and the allocation of taxes are seen to be unfair – and unreformable within the mechanisms of the existing political system – then fiscal factors may play a role in motivating people to

take up arms to resolve by force what they cannot get through peaceful means. The other side of this coin is the use of the public finances (and a deliberately opaque budgetary and revenue system) to provide personal wealth for the powerful (for example, the Charles Taylor regime in Liberia). Once conflict has begun, it affects the ability of states to raise revenues, it causes major reallocations of expenditure and, depending upon how the wartime fiscal deficit is handled, it affects macroeconomic stability. Public revenues usually fall to very low levels in conflict-affected countries. Revenues from indirect taxes fall as economic activity shrinks, the quality of tax institutions declines and governments become evermore dependent on import duties and other trade taxes (but the latter also tend to decline as external trade shrinks and as the quality, and honesty, of customs services deteriorates). Poor governance also reduces the legitimacy of taxation, and encourages tax evasion. The fall in revenues accordingly reduces the ability of governments to fund development expenditures.

Public expenditure management, revenue mobilization and the overall (macroeconomic) fiscal framework are all crucial issues for post-conflict reconstruction. Resolving long-standing grievances over the distribution of publicly provided services and infrastructure (where differences in access by groups of people often take on ethnic, religious and/or regional dimensions) requires funding: success in revenue mobilization is therefore important to the chances of constructing a workable peace. Efforts to raise public revenues and to stabilize the public finances, must be designed to ensure that recovery is *broad-based*, so that the majority of people, not just a narrow elite, benefit.

In summary, any assessment of fiscal policy and development cannot ignore conflict – especially in low-income countries in which all the world's civil wars presently take place. Hence this chapter highlights the main issues of fiscal reform in conflict-affected countries, with a particular emphasis on revenues. We do not attempt a comprehensive survey of country experiences; instead, relevant country examples are used to illustrate the main themes. In the next section, the chapter discusses conflict's fiscal effects. We then move on to consider fiscal management in 'post-conflict' countries, emphasizing the often-neglected importance of fiscal reform to securing peace and the tasks of institution-building. The final section concludes by summarizing how fiscal reform can contribute to broad-based recovery.

## **The fiscal impact of conflict**

### **Conflict's revenue impact**

Belligerents have strong incentives to maximize resource-mobilization for their military needs. The government of Sri Lanka enacted a number of revenue reforms to fund a defence budget that was absorbing some US\$1 billion annually until the peace agreement with the country's Tamil rebels