Final Report

*Peace and Development*

*Democratization, Poverty Reduction and Risk Mitigation in Fragile and Post-Conflict States*

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Introduction
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For much of the early postwar era, Western development aid policymakers assumed that “all good things came together,” allowing them to focus policy on one dimension such as economic growth with the expectation that other goals, including political stability and democracy, would also be achieved as a direct consequence (Huntington 1968; Packenham 1973). While the increasing political and economic instability of the 1960s and 1970s exposed the naiveté of this assumption, beginning in the 1990s in the aftermath of the Cold War, Western donors have effectively adopted a similar approach when addressing the new challenges posed by fragile and post-conflict states. Understandably, donor countries have focused on the imperative of ending conflict and maintaining peace, assuming (or at least hoping) that the short term arrangements required to stop the violence would ultimately lead to both economic development and democracy. This study takes as its starting point a simple question: do policies designed to ensure peace necessarily lead to later advances in development and democratization?

Although this question is relatively straightforward, trying to find meaningful answers was much more challenging. First, we felt it was important to include in our research team researchers from both the developed countries of the North and the developing South. This is a necessary corrective to the inevitable biases of Northern perspectives on fragile and post-conflict states, and a principal secondary goal of the project was to develop a more effective North-South dialogue for developing better theories. At the same time, we also hoped to encourage greater South-South dialogues through discussion of the various cases by the seven case-study teams. Second, we felt that only a genuinely multidisciplinary approach could begin to untangle the complexity of each case. To achieve this, two researchers, an economist and either a political scientist or sociologist, were commissioned in each country included in the study. Finally, we wanted to include a range of countries in the study. To that end, we conceptualized the selection of seven countries in this way:

1) **Relatively Stable Power sharing Arrangement with Positive Economic Outcomes**: Bosnia and Mozambique fall into this category.
2) **Prolonged Lack of Stable Power sharing with Negative Economic Outcomes**: Sri Lanka and Sudan.
3) **Indeterminate Power sharing Arrangements**: The remaining three cases are distinguished by the fact that they lack stable power arrangements, with different consequences. Rwanda stands out because it has realized considerable economic success despite the lack of any power sharing arrangement between the two dominant ethnic groups. In contrast, Colombia stands out because it enjoys the dubious distinction of having both the longest civil war in Latin America and one of the longest periods of uninterrupted political democracy in the region in terms of regular elections. Recent events suggest that the civil war is now in its last phases and may be entering a phase in

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1 The project began with two principal investigators: Philip Oxhorn from McGill University and Ibrahim Elbadawi of the World Bank. Dr. Elbadawi left the Bank early in the project and was replaced by Gary Milante, although he remained on the project’s advisory committee. That committee also included Aristide Nononsi from McGill University and Samir Makdissi from American University of Beirut.
2 Sri Lanka’s conflict ended with the military defeat of the Tamil guerrillas mid-way through the project.
which new power sharing arrangements will be forged. Lebanon may be backsliding in terms of power sharing as recent political instability (including a short term military incursion by Israel) may have undermined the relatively successful power sharing arrangements that brought an end to a prolonged period of civil war. Partly as a consequence of these still indeterminate power-sharing arrangements, all three cases have experienced less than positive economic outcomes.

To help guide the study, five thematic papers were commissioned by the World Bank and are included in the second part of this volume. Drafts of these papers were presented in the initial project workshop, held at McGill University in November 2008. In part based on these thematic papers, detailed case study guidelines were prepared by the advisory committee (see Appendix 1). More specifically, the authors of the case studies were asked to address three specific sets of questions:

1) **Power sharing for Peacebuilding and Development**: It is vital to the peace and prosperity of states that their monopoly on violence is ensured, but this raises the danger that the power of “strong” states will be abused. To better understand these potentially countervailing effects, the study will center on how peace agreements, intervention strategies, demobilization strategies, and arrangements for post-conflict justice contribute to securing the peace and economic development. What are the trade-offs in peace and development associated with peace agreements that increase fiscal decentralization and political federalism? How can reforms of the military and security apparatus contribute to poverty reduction and when does it reduce the risk of new or resurgent conflict? What security sector reforms are possible in the post-conflict environment and are there hard limits to the extent of these reforms? In essence, does security always trump development?

2) **Participatory Governance and Service Provision**: The available literature suggests that some form of participatory system is a prerequisite for a sustained peace; however, it is not clear that an ensuing democratic or participatory system has any advantage in the provision of public goods. Similarly, some literature suggests that while more participatory systems in socially fractionalized societies with strong identity politics may confer the legitimacy necessary for peace, such systems might sacrifice accountability if they create new opportunities for patronage and clientelism. Finally, while there is good evidence that suggests established democracies are better able to provide voice to the aggrieved, reducing the likelihood of civil conflict and securing civil peace, democratization is not a panacea against civil conflict, particularly if post-conflict elections may simply move the risk of conflict to a future date. This suggests a possible trade-off: When should efforts be made to democratize and reduce the risk of civil conflict and when should existing systems of government be maintained and even reinforced with bureaucracy to help ensure stability and efficiently provide public goods? How can participatory systems be effective as an instrument for the delivery of public goods and services specifically for post-conflict and fragile states? What are the options for public/private ownership in post-conflict reconstruction and what is the role of the international community in advising economic reforms for these types of states?
The Economic Agenda for Post-Conflict Reconstruction: Previous research produced theoretical and empirical evidence that countries emerging out of conflicts experience certain structural shifts that affect aid effectiveness and fiscal policy, as well as exchange rate and monetary policy. This study will build on this research by addressing the following question: How can these disparate effects be integrated into a coherent macroeconomic policy agenda for fragile and post-conflict states, based on a thoroughly developed theoretical framework? Questions that remain include, for example: Can expansionary monetary policy be used to pump-prime development or should post-conflict inflation be avoided at any cost? When do sovereignty issues associated with national currencies become liabilities to a fragile state? If budget support and public good provision subsidize government expenditure in post-conflict states, when does international aid support coherent macroeconomic strategy and when might it threaten to undermine one?

Managing a research team of over 20 people literally spanning the globe was no easy task, but the outcome was more than worth the effort. Aside from the immense logistical challenges this entailed—further complicated by disciplinary and linguistic hurdles that had to be overcome—the experience was sobering in many respects. From a Northern perspective, established researchers came to realize that our theories did not always conform to the realities faced by countries in the midst of conflict or that have recently restored some semblance of peace. From a Southern perspective, even if Northern theories are less than ideal, they did lead each researcher to approach their realities in different ways by asking new questions. At the same time, through their interaction with other researchers from fragile and post-conflict states, they often gained a new appreciation of the value of comparison and the relative uniqueness of their own country’s experience.

The principal findings of the project can be grouped into six general areas: 1) the decisive role of international factors; 2) the need to guard against excessive institutional rigidity; 3) the minimal contribution of state decentralization to long term peace, development and democracy; 4) the promise of political democracy for achieving lasting peace; 5) the importance of informal institutions; 6) the indeterminacy of micro- and macro-economic policy.

THE DECISIVE ROLE OF INTERNATIONAL FACTORS

International factors and influences are generally decisive regarding the possibility for conflict resolution and the form it takes. While this is often due to the central role that international factors played in the initial conflict, their impact on conflict resolution is also fundamentally a reflection of economic resources, political influence and, in some cases (e.g., Bosnia and Herzegovina), military intervention. This inevitably means that key international actors will bear a high level of responsibility for setting the criteria and modalities for conflict resolution will.

In particular, international actors play a dominant role in determining which actors participate in conflict resolution negotiations. In general, the result is that the most heavily armed groups are the ones who are included. While this inevitably reflects a certain balance of power among key combatants, it has tended to exclude civil society actors and smaller (armed and/or unarmed) political actors. This inevitably gives such processes a conservative bias that recognizes the importance of violence for winning a seat at the negotiations and creates barriers
to new entrants in the future. As the case of Sudan, in particular, demonstrates, this bias can contribute to the eruption of post-conflict violence. Similarly, the resulting dynamic means that post-conflict development efforts remain elitist, excluding potentially important actors and precluding effective civil society buy-in more generally, raising important questions of legitimacy. Of the cases studied, Rwanda represents an important exception in that the post-conflict government deliberately reached out to civil society through a variety of mechanisms, including a national referendum and new constitution. Mozambique also represents an important exception in that it deliberately rejected international pressures for a formal power sharing agreement between the two principal armed groups in the conflict. While this rejection did not necessarily allow for greater civil society inclusion and legitimacy, it did help Mozambique avoid important sources of institutional rigidity after peace was restored and help pave the way for democratic elections—points I will return to below.

International aid generally plays a central role in post-conflict and fragile states. Such aid includes development assistance and humanitarian aid, and seems unavoidable. Yet the flipside of its necessity is the danger of aid dependency. Such dependency is problematic because it can unintentionally undermine the emergence of the kind of productive economic activity essential for employment creation and higher standards of living. This runs the danger of creating a vicious cycle similar to the so-called “resource curse” associated with high levels of rents from the export of natural resources. At the same time, aid-dependent countries are vulnerable to the political dynamics of donor countries—something that is particularly dangerous given increasing levels of government austerity since the 2008 economic crisis. In some cases, a third problem arises when international actors, particularly through post-conflict development assistance, serve as a target for nondemocratic actors who allege excessive external influence. This is particularly true regarding NGOs, both national and international, who are the direct recipients of international funding. To avoid these problems, donors must develop longer range planning focusing specifically on its contribution to sustainable economic development, including clear timetables for weaning countries of such aid.

THE NEED TO GUARD AGAINST EXCESSIVE INSTITUTIONAL RIGIDITY

More specifically, institutional inflexibility creates three inter-related challenges that run the risk of creating a vicious cycle leading to future violence. The first is that power balances among key actors at the time peace is restored are reflected in the state institutions in a way that prevents adaptation to changes in those power balances due to demographics, economic change and/or the emergence of new actors. The latter issue also raises the problem of how “old” actors might evolve. Institutional rigidity can have the unanticipated effect of freezing the basis of political representation and participation, prevent the emergence of alternatives, including ones that might arguably be more conducive to longer term peace, democracy and development. This is clearest in the case of Lebanon, where the sectarian basis of politics was enshrined in the peace accords has increasingly distorted politics in potentially destabilizing ways. It is also important to note that such actors may not be “new,” but were excluded in the initial peacemaking processes and subsequently find it difficult to achieve inclusion post-conflict.

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3 Colombia is also an exceptional case in that US policy has increasingly favored militarization in order to defeat the guerrilla groups, undermining democratization processes and the potential negotiated settlements.

4 This is particular tragic in the case of Lebanon because similar institutional rigidities played a direct role in igniting the initial conflict.
A second problem created by excessive institutional rigidity is that actors adapt to it by creating a variety of informal institutions that over time undermine state capacity and legitimacy in fundamental ways. They tend to feed processes of rent seeking, corruption and clientelism. Inflexible, often closed institutions are bypassed by political actors, further weakening the capacity of the state to design and implement effective policies. At the same time, authoritarian tendencies are exacerbated because formal political participation is sharply curtailed and/or increasingly irrelevant as informal mechanisms dominate political decision-making.

Finally, institutional rigidity has meant that restrictions on democratic processes that may have been perceived as necessary for achieving peace are increasingly difficult to reverse. In many ways, such perceptions become a self-fulfilling long-term prophecy, as the initial fears of democratic politics seem to be vindicated by increasingly undemocratic practices caused by the inability to enact institutional reform. At the same time, the parties included in the peace agreements have increasing incentives—fed by rent seeking and corruption—to block changes that would affect their privileges by broadening democratic inclusion.

THE MINIMAL CONTRIBUTION OF STATE DECENTRALIZATION TO LONG TERM PEACE, DEVELOPMENT AND DEMOCRACY

State decentralization has generally not contributed to long-term peace, development and democracy in the countries included in this study. In fact, particularly in Lebanon, Mozambique and Sri Lanka, decentralization policies frequently raised fears of national fragmentation, if not disintegration. This only tended to exacerbate conflict rather than contribute to its attenuation.

At the same time, decentralization has often been a source of power for nondemocratic actors. This has only compounded problems of corruption, weak state institutions, and clientelism. In the case of Colombia, decentralization also enabled revolutionary groups and rightwing paramilitary groups to expand, thereby feeding rather than curtailing the conflict.

An important exception among the cases studied is Rwanda, where decentralization policies became a pillar of post-conflict reconstruction. It is important to note that decentralization was explicitly adapted to the national historical and cultural context, and coordinated by a national long-term development plan. In this way, institutions of local governance became the basis for achieving good governance, pro-poor service delivery, and sustainable socioeconomic development. Traditional institutions such as Ubudehe (focusing on poverty reduction and the creation of social capital); Gacaca (utilized to facilitate free speech and participation in genocide courts); and Ingando (contributing to reconciliation, social recapitalization, and active citizenship) played a direct role in strengthening the Rwanda regime by promoting justice, reconciliation and economic development. More generally, decentralization may also have helped democratize some of the autocratic tendencies emanating from the Office of the President.

THE PROMISE OF POLITICAL DEMOCRACY FOR ACHIEVING LASTING PEACE

If a consensus can be reached among key actors that political democracy is the appropriate post-conflict form of government, it offers important advantages for ensuring longer term peace and development. As the case of Mozambique demonstrates, electoral mechanisms can overcome problems of excessive institutional rigidity associated with achieving peace. It also provides the

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5 For a similar argument about the role democratic institutions can play in peace building, see Rustow (1970).
best avenue for ensuring civil society’s inclusion and minimizing elitism, as Rwanda
demonstrates. Conversely, as the case study of Sudan argues, if democratic institutions are not
sufficiently emphasized in the peace-making process, the likelihood that democracy will be
successfully achieved post-conflict is severely constrained.

Support for democracy also offers a potentially ideal channel for international assistance
by focusing it into building credible electoral institutions and strengthening political parties.
Unlike direct assistance to either the government in power or civil society organizations, it is less
subject to political manipulation, minimizing potential allegations of inappropriate partisanship
or excessive external influence. This is because such assistance is by its nature politically neutral
in that all political positions should be favored equally. The successful development of
democratic institutions also can contribute to the strengthening of mechanisms for setting
national priorities, which can be used to counter or mediate excessive international influence.
Ultimately, it provides a potentially effective set of institutions for future conflict mitigation
before violence flares up.

Finally, this is an area where international donors generally have considerable expertise
and relevant experience. Yet it is imperative that international donors respect national and local
histories, adapting “Western” institutions to the cultural norms and preference of fragile and
post-conflict states. It is also essential that donors respect local timelines for realizing political
democracy that are appropriate. As recent experience in many countries attests, it is relatively
easy to raise democratic expectations even in countries with little actual experience in
democracy. That same experience also highlights that it is far more time consuming, if not
necessarily more difficult, to build appropriate institutions so that elections are held in a
relatively free and fair manner. The danger when elections are rushed to meet donors’ own
domestic agendas and deadlines, leading to frustration or worse when the promised elections fail
to live up to minimal standards of fairness.

**THE IMPORTANCE OF INFORMAL INSTITUTIONS**

Informal institutions played a pivotal role in all cases included in this study. Yet their
contribution to peace, development and democracy is ambiguous. In general, informal
institutions seem to have exacerbated the negative longer term consequences for achieving
development and democracy associated with peace settlements. This is because they undermined
the formal institutions necessary for political stability, accountability and responsiveness. Rather
than mitigate or prevent future conflict, they threatened government legitimacy and raised the
prospect of future conflict as a result. When bounded by a commitment to political democracy on
the part of key actors, however, informal institutions can contribute to a positive relationship
between peace, development and democratization. This is because they can help compensate for
excessive institutional rigidity in a positive way that brings new actors in, encourages existing
power holders seek greater social legitimation.

**THE INDETERMINACY OF MICRO- AND MACRO-ECONOMIC POLICY**

In many ways, the micro- and macro-economic policies pursued in each case were sui generis.
While all countries shared the same general goals (e.g., economic growth, employment creation,
etc.), the actual policies they adopted were determined by other factors. These included external
imposition and aid conditionality (e.g., the adoption of a currency board in Bosnia and
Herzegovina), the specific national context (e.g., the importance of oil in Sudan) and history (e.g., Mozambique’s socialist past), as well as the nature and extent of the destruction associated with the conflict. In particular, the nature of any power sharing agreement seems to have been decisive, creating both incentives for particular policies as well as distorting the normal functioning of economic and market dynamics. While the case studies provide a rich discussion of such policies, their varied nature and outcomes makes it all but impossible to draw useful comparative conclusions.

MOVING FORWARD

As the following chapters demonstrate, the project generated an impressive quantity of rich empirical and theoretical material. In the process it showed the value of multidisciplinary research that deliberately enhances the value of comparative research by bringing Southern and Northern researchers into a direct dialogue.

In many ways, however, the research is only a first phase in a larger project that both deepens our understanding of the often contradictory ways in which process for establishing peace interact with processes of economic development and political democratization. Equally important, more work needs to be done in translating research into better practice. As a necessary first step in that process, the current project has begun to question both earlier theories and past practices in a constructive way that can point future researchers in the right direction. After all, only be better articulating current problems and highlighting successes can we begin to correct the fundamental challenges facing fragile and post-conflict states.

REFERENCES


Case Study: Bosnia and Herzegovina

Merima Zupcevic and Fikret Causevic

BACKGROUND

The 1980s were marked by a deep political and economic crisis in Yugoslavia. At the beginning of the 1990s, new political parties appeared, including in Bosnia and Herzegovina (then the Socialist Republic of Bosnia and Herzegovina, one of Yugoslavia’s six republics). In 1991, the parties that swept the elections—many with names including “democratic” and ethnic prefixes—were expected to replace the one-party communist regime with a pluralistic, democratic political structure. Citizens’ hopes also were high that the new political order would find ways to strengthen the republic’s severely shaken economy.

Historically, there have been three major ethnic groups in Bosnia and Herzegovina. These are: Bosniaks (religious Muslims), Croats (Catholic Christians) and Serbs (Orthodox Christians). Since Yugoslavia was a largely secular and socialist country, the differences in ethnic and religious belonging were for the most part not pronounced up until the time preceding the 1991 elections. The elections’ seemingly positive change ended up being a fatal one. The new political elite soon started inciting ethnic tensions and renewing nationalist ideologies. At the same time, economic decentralization inherited by the new regime fed corruption and crime that thrived as a consequence of weak state control.6

This political and economic chaos culminated in a series of wars, the one in Bosnia starting with the proclamation of independence from Yugoslavia in April 1992. The Bosnian War was the most brutal. A research study done by the Research and Documentation Centre, War Crimes, points to an overall total of approximately 113,000 fatalities, 40 percent of which were civilians. This same study, cited by Pål Kolstø, says that the “total death toll in Bosnia-Herzegovina was 100,000, including both fighters and civilians, of whom 65.8 percent were Bosniaks, 25.6 percent Serbs and 8.01 percent Croats. Bosniaks, however, made up as much as 83.33 percent of all civilian victims.”7

The war ended with the internationally mediated General Agreement for Peace in Bosnia and Herzegovina, known as the Dayton Peace Agreement because it was negotiated in Dayton, Ohio, in 1995; the agreement was signed in Paris on December 14, 1995. Two main goals of the Dayton Agreement were to end the war and rebuild a “viable Bosnia.”8 The Dayton Agreement set up a complex power-sharing system that determined the way the reconstruction strategy was to be implemented and has directly characterized the peace process itself. Externally-led fiscal and monetary policy arrangements agreed on in Dayton Agreement have paved the way for Bosnia’s macroeconomic stabilization.

This study will attempt to shed light on post-conflict development in Bosnia and Herzegovina (BiH) with regard to the country’s power-sharing system, governance solutions,

6 Donais, 2003; Bougarel, 1996.


and macroeconomic developments with the aim of drawing conclusions and lessons for the future.

The Dayton Agreement called for Bosnia and Herzegovina to be divided into two main entities: (1) the Federation of Bosnia and Herzegovina (FBiH) is the Bosniak and Croat entity, and (2) the Republic of Srpska (RS) is the Serb entity. In 1996, the Brcko District (BD), located in northeastern BiH, became a neutral, self-governing administrative unit and part of both entities. In 2000, the International Arbitration Commission established the Brcko District as a separate district with its own budget, financing the same functions and services as the cantonal and municipal budgets within the FBiH.

POWER SHARING IN POST-CONFLICT BIH

Post-conflict power-sharing trends and instruments

The role of international factors in peace building

Strategies to assist post-conflict countries to recover from “new” wars focus mainly on introducing an externally controlled set of governance principles that aim to ensure sustainable peace and stability. Bosnia’s peace model is based on conventional strategies, using both top-down and bottom-up peace building with a strong international presence in both governance and implementation. Actors that employ the orthodox model are state officials, international organizations, international financial institutions (IFIs), and NGOs. They work jointly on building the country’s institutions and infrastructure to address political, economic, developmental, and social needs.

The transition package introduced in BiH is based on the policies outlined in the Washington Consensus, with recommendations related to macroeconomic stability, privatization of the business sector, regulatory reforms, and economic development. Policies in these areas have formed the backbone of the BiH Country Assistance Strategies (CAS) implemented by the World Bank, the European Union, the U.S. Agency for International Development (USAID), and other international organizations and agencies in cooperation with domestic authorities.

Given the ambitiousness of plans and the chaotic state of affairs in BiH, it is natural that actors representing the international community (IC) played leading roles in peace building. Domestic authorities, divided and inexperienced, were not capable of planning reforms independently, especially at the beginning of the process. The IC also financially supported all these efforts, which gave it leverage over BiH governmental institutions in principles and policies introduced and institutional backing. Although the IC’s approach yielded plentiful results, it contained one major flaw. The Dayton Agreement’s peace model, based on “democratic principles” to deal with BiH’s post-conflict environment, ensures that international

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9 “New” wars are those in which countries suffered from an intrastate conflict followed by the loss of sovereignty and by economic disintegration; therefore, their post-conflict recovery takes place in a specific recovery environment.
10 The Washington Consensus, a list of policies considered necessary for a developing country’s economy to undergo successful reform, was developed in 1989 by John Williamson and was envisaged primarily for Latin American developing economies.
stakeholders hold real power and that domestic institutions are considered responsible only for development. This imbalance of power, with the international community wielding much more authority than local leaders, continues to be a fundamental flaw in the peace model. As long as BiH citizens are not allowed to be in control of their own country, the peace model’s “democratic principles” will be empty words on a document.

The role of the internationally led Office of the High Representative (OHR) is the most controversial part of the Dayton Agreement’s peace model. While, in the beginning, this institution was needed to ensure that the international community’s recommendations on how to lead the new, complex country were being implemented, it has been transformed into a stumbling block for proper democratization. The “Bonn Powers,” which allow the high representative to overrule legislation and impose executive decisions, helped prevent nationalist-motivated political decisions in many instances. They also helped remove from power some corrupt politicians. For example, at the time when Paddy Ashdown was the high representative (2002–2005), some top party officials were removed from the political scene and banned from political activity due to their criminal history, nationalist rhetoric, or involvement in scandals. However, when Christian Schwartz Shilling came to the high representative position in January 2006, and started lifting vetoes on corrupt politicians and remained passive during crises involving state-level authorities that could have led to serious destabilization, it became clear that the strength of the OHR had diminished. While this could be seen as good for democracy, it actually gave a boost to renewed nationalist rhetoric. Subsequent high representatives, Miroslav Lajcak and – the current high representative, Valentin Inzko, have not managed to restore the strength of OHR that seems to have been lost with the departure of Paddy Ashdown in 2005.

The role of the international community has changed with time, with its focus turning toward trying to integrate the country into regional trends and to ensure BiH’s accession into the European Union. In a 2007 report by the United Nations Development Programme (UNDP), analysts concluded that the political situation in BiH was worse than it had been in earlier post-war years. Hence, we can conclude that instead of the international community becoming redundant in the long peace process, its role is perhaps more relevant than ever, as the country is at a clear crossroad and needs guidance to escape a prolonged status quo. One road leads toward stagnation, isolation, and destabilization, and the other to the safe haven of the EU.

*Domestic political structures and their impact on peace building*

Political parties in BiH are demonstrating surprising resilience. The same political structures and parties that ruled over the political scene in the late 1980s are still the strongest parties or political streams in the country. Those are the predominantly Bosniak Party for Democratic Action (SDA), the Croatian Democratic Community (HDZ), and the Serb Democratic Party (SDS), and they can be considered as representing exclusively one ethnic group. They have survived the war and—with the exception of the SDS—are now as strong as or stronger than ever. The SDA has been accompanied by the Party for Bosnia and Herzegovina (SBiH), whose leadership (composed mainly of ex-SDA politicians) is a strong advocate of a unitary state, with

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13 High Representatives are elected by the internationally formed Peace Implementation Council (PIC) and are always foreigners.
14 He stayed at the position until July 2007, when he was replaced by Miroslav Lajcak, a Slovak diplomat.
constant invocations of the past and the suffering of the Bosniak people. The SDA, SBiH, and HDZ are dominant in the Federation of BiH.

The SDS has been pushed aside by the Alliance of Independent Social Democrats (SNSD) in the political arena of the Republic of Srpska. While SNSD entered the political scene as a seemingly progressive and liberal party, it has become the strongest advocate of an anti-unitary governmental system, ethnic separation in institutions, and even dismemberment of the country based on entity lines. The SNSD leadership’s invocation of Dayton-ensured ethnic quotas and the predominantly Serb entity with vast competencies are considered by the authors of this report to be major impediments to a more pronounced stabilization because the reform process is based on reducing the elaborate governmental system, increasing state-level competencies, overcoming ethnic separation, and ensuring the sustainable return of refugees and displaced persons. These aspects of the reform do not serve nationalist agendas.

Most disturbingly, such politics can be directly linked to those who wish to perpetuate ethnic segregation. Three different school curricula are being used simultaneously to accommodate different historical and cultural views. Ethnic quotas are being applied in the public administration (one of the largest employers). And areas that were deemed ethnically neutral because of the war and the non-return of refugees are being populated by secluded communities in which nationalism dominates. Consequently, the existing political structures are not contributing to peace building; instead, the ways in which these structures operate appear to be preventing a more efficient stabilization process.

Dayton Peace Agreement as a power-sharing instrument

The Dayton General Framework Peace Agreement was initialed in Dayton, Ohio, on November 21, 1995, and signed in Paris on December 14, 1995, by the heads of state of Bosnia and Herzegovina, Croatia, and the Federal Republic of Yugoslavia. Mediation came about due to international application of military force against Serb positions at different locations throughout the country, the threat of future use of force, and Serb military defeats in the autumn of 1995.

The Dayton Agreement itself is a collection of provisions and annexes designed to deal with issues that negotiators expected would arise once the war had ended. It also includes a state Constitution. As a general framework agreement, its implementation has brought about a constant need for domestic and IC institutions to make judgments, interpret provisions, and develop strategies ad hoc.

Eleven annexes to the agreement deal with military and civilian aspects of implementation. All aspects were to be ensured by IC implementers: NATO Implementation Force troops were to ensure an end to hostilities, the Organization for Security and Cooperation in Europe (OSCE) was designated to organize the first elections, UN and EU agencies were to ensure the return of refugees and human rights protection, the European Bank for Reconstruction and Development and the World Bank were to revive public corporations, the UN was to lead an International Police Task Force, and the Office of the High Representative (a new institution)

\[^{16}\text{The Dayton-created Constitution introduced ethnic voting as well as quotas in state institutions. It also cemented the country’s political setup of two entities, FBiH and RS, and is being (ab)used as an ultimate proof of the right to certain levels of independence within the state framework. This will to emphasize independence is particularly pronounced in the Serb-dominated Republic of Srpska.}\]

\[^{17}\text{Serbian and Croatian presidents represented Bosnian Serbs and Croats.}\]

\[^{18}\text{Austermiller, 2006.}\]
was to be in charge of the overall civilian implementation. These agencies were originally supposed to oversee the transition of power to Bosnian authorities for one year; however, after one year, they extended their mandate for two additional ‘consolidation period’ years, and in 1997, they extended their mandate indefinitely. BiH authorities did not have a say in any of this because the Peace Implementation Council (PIC) has unilateral power to decide which entities will be in control and for how long, and the PIC will be the final arbiter to decide when the Office of the High Representative will be ended.

The state of Bosnia and Herzegovina (BiH) is organized as a parliamentary democracy containing two main entities: the Federation of Bosnia and Herzegovina (FBiH) and the Republika Srpska (RS). Besides the two main entities, the Brcko District, located in northeastern BiH, became a self-governing district in 2000. The FBiH and the RS both have three levels of authority: state (BiH), entity (either FBiH or RS), and local. The local level of authority is municipal; together the two entities have are a total of 146 municipalities.

The BiH Constitution devolves most governmental authority to the two entities, the Bosniak-Croat FBiH and the Serb-majority RS. The FBiH has an additional level of authority composed of 10 cantons; under each of the cantons are municipalities. The FBiH’s authority has mostly devolved to the cantons. This is due to the inability of the Bosniaks and the Croats to agree on the issues that are considered national interests of one particular ethnic group. This “cantonized” entity has always been dysfunctional and is divided along ethnic lines.

Figure 1. The State of Bosnia and Herzegovina Divided into Entities of the Federation of Bosnia and Herzegovina and the Republika Srpska

Source: http://www.nato.int/SFOR/indexinf/125/p03a/b01p031c.gif

The two entities have been allowed to carry out their own policies. Economic development has been impeded by political complicities and disagreements, and final

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19 Chandler, 2000, 271.
20 Fifty-five countries form the PIC and support the peace process in different ways. The PIC has been vested with authority to review the OHR's reports on an annual basis.
accountability for most political decisions falls on the High Representative. Stated simply, there is no local ownership, and lines of confrontation were simply reaffirmed through the Dayton Agreement. Thus, it can be said that the power-sharing structure makes it difficult to establish national policies, and the High Representative fills the resulting power vacuum. Although increased state-level competencies can be noted in the justice, military, and civilian affairs sectors, most of the competencies remain at the entity level: for example, education, health, police, economic affairs, and energy. The two entities, with their separate institutions and budgets, de facto exist independent of one another.

The Dayton Agreement did not remove the existing political structures, but it empowered wartime political elites to lead the post-conflict reconstruction and development process. As a consequence, the country has been faced with a political status quo, reinforced by nationalist politics and with little to no incentives for badly needed reforms. Accessibility of power to many due to the elaborate governmental system, guaranteed positions based on ethnic quotas, and easy access to public goods only increased incentives for an even longer stagnation. The peace accords avoided creating any “national consensus” and instead institutionalized the pre-existing differences.

PARTICIPATORY GOVERNANCE AND SERVICE DELIVERY

Development and peace building

The most prominent development projects

The first development projects focused mainly on economic recovery. The focus later expanded to political and social reforms, with the European Union playing a major role. In 2000, the EU initiated a new development program for Western Balkan countries called CARDS (Community Assistance for Reconstruction, Development and Stabilization). The program has focused on reconstruction, democratic stabilization, reconciliation, and the return of refugees; institutional and legislative development, including harmonization with EU norms, the rule of law, human rights, civil society and the media; sustainable economic and social development, including structural reform; and promotion of regional cooperation.

A prominent sub-project for state capacity building has been the Public Administration Reform (PAR) project, which is also the focus of the BiH Mid-Term Development Strategy. An overlap of functions and responsibilities among different levels of authorities, as well as weak coordination and cooperation were seen as the greatest obstacles to more efficient public administration. Total CARDS funding in the 2001–2006 period for Administrative Capacity Building and PAR follow-up was EUR40 million.

The second largest donor after the EU is the United States. USAID projects have greatly contributed to reconstruction and development. In the 1996–2000 period, USAID disbursed US$890 million in assistance that focused on refugee return, infrastructure reparations, and private sector support (banking sector and small and medium-sized enterprises development).
Current USAID projects cover multiple sectors and have shifted their focus from post-conflict assistance to transformational development and center around private sector development, as in strengthening civil society, helping political parties introduce and practice democratic principles, justice sector and legal framework support, local-level development, and media support.25

While it can be said with certainty that all donor programs have contributed to some extent to development efforts, lack of coordination has been a dominant concern. Donors often implement similar projects with similar outcomes. That is why, for example, there were local administration development projects by USAID and the OSCE that were noticeably similar and implemented in the same municipalities.26

A significant recent addition to external funding by the European Union for accession countries is the introduction of the Instrument for Pre-Accession Assistance (IPA) funds. IPA funds supersede previous pre-accession instruments (including CARDS) to unite development efforts in pre-accession countries, BiH included, for the 2007–2013 period. The five components of IPA are Transition Assistance and Institution Building, Regional and Cross-Border Cooperation, Regional Development, Human Resources Development, and Rural Development.27 These funds are widely acknowledged as a chance to complete the needed reforms in terms of post-conflict development, while speeding up the EU-accession path. From 2007–2013, BiH is scheduled to receive EUR 488.2 million.

As for domestic development tools, the BiH Mid-Term Development Strategy, prepared in April 2004 by domestic as well as international experts, served as the main document for tracking BiH economic development from 2004 through 2009. Treating almost all macroeconomic indicators, coupled with others developed by the European Bank for Reconstruction and Development (EBRD), the International Monetary Fund, and the World Bank, this BiH Mid-Term Strategy presented an economic agenda for the designated six-year period from 2004 through 2009. In 2005, domestic and international experts began to express concerns that the BiH Mid-Term Development Strategy had failed to fulfill its function—to serve as a starting point for the creation and implementation of the national economic agenda and not just serve as a tool to implement reform measures.

The Strategy’s priorities for public administration reform were to conduct a functional review at all levels of government and to reinforce the administrative capacity of BiH for European integration. Most of the technical Public Administration Reform requirements were fulfilled, but the size and lack of functionality of the many levels of authority and the lack of political agreement on constitutional and EU questions impeded progress in this field.

Obvious high dependence on international aid and international expertise, however, will continue to be impediments to domestic resources employment and development. If this dependence is gradually overcome through educational reforms, targeted training, and a gradual withdrawal of the international cadre and if appropriate state and business mechanisms are developed, these numerous reforms will not only be concepts, but will be implemented properly. Also, if BiH could achieve sufficient economic development in a sustainable manner, its need for international assistance would be reduced, allowing the country to function independently without funds and interventions from the international community.

25 Ibid.
27 See the Delegation of the European Union to Bosnia and Herzegovina's website for more details and additional, up-to-date information.
EU accession process as a peace-building tool

Given the geo-strategic position of BiH, it was clear from the beginning of post-war reconstruction that the peace-building process needed to be accompanied by a strategy for eventual integration of the country into the EU. In 1999, the EU proposed a Stabilization and Association Process (SAP) for all countries of Southeast Europe (SEE), which includes BiH. By June 2000, all SAP countries (Albania, BiH, Croatia, the former Yugoslav Republic of Macedonia, Serbia and Montenegro) were declared “potential candidates” for EU membership.28 At the Thessaloniki Summit in 2003, the SAP was confirmed as the EU policy for the Western Balkans.29 In BiH’s immediate neighborhood, Croatia has come a long way toward EU-accession, and Serbia and Montenegro are also progressing, although more slowly. BiH has had—in contrast with the other Western Balkans countries—a more difficult and complex task of engaging fully in the EU integration process, as major issues that fall in the realm of post-conflict reconstruction, recovery, and reconciliation have not been completely resolved.

Institutions representing the international community in BiH have realized that the cost-effective thing to do to ensure the implementation of some post-conflict development tasks is to include them in the EU-accession agenda. Conversely, as long as war issues are unresolved, BiH does not stand a chance of being fully integrated into the European family. A very important premise behind the EU-accession logic is that EU integration is one of the rare issues that can unite societies and, thus, most political segments. In that context, EU-accession has become a peace-building tool in BiH.

The mission was clearly set out in the Feasibility Study developed in 2003 for negotiations between BiH and the EU on a Stabilization and Association Agreement.30 Sixteen priority areas were identified in relation to a Report of the European Commission to the EU Council of Ministers, and six short-term priority areas from the European Partnership. These were more effective governance and public administration, effective legal provisions on human rights protection, effective judiciary, tackling organized crime, asylum and migration, customs and tax reform, budget legislation, budget practice, reliable statistics, comprehensive and consistent trade policy, integrated energy market, development of BiH economic space, and public broadcasting.31

Evidently, this agenda is in full compliance with the peace-building agenda. From approximately 2003, the peace-building agenda was replaced by the EU agenda with consistent goals and a higher probability for success in politically sensitive areas. However, BiH’s road towards EU membership between 2003 and 2008 demonstrated institutional resistance wherever the national interest of ethnic groups was perceived to be at risk. It is obvious from the Enlargement Strategy and Main Challenges 2008–200932 document that most accession criteria have not been fulfilled or are still in the process of being fulfilled.

Overall, the EU accession process has not yet accomplished the goal of bringing sustainable peace to BiH. A lack of political consensus on the major issues of state building and

28 See www.europa.ba.
29 European Council, Declaration from the EU-Western Balkans Summit, Thessaloniki, June 21, 2003.
31 Ibid.
the ongoing challenges of the Dayton Peace Agreement are based on the same unresolved animosities evidenced by inflammatory ethnic rhetoric and lack of unity in the EU-accession process. This makes it clear that BiH’s citizens and their representatives have not matured enough to submerge ethnic identities into a wider, European identity. Yet, EU accession seems like the best way to resolve power-sharing problems and eventually to achieve economic development and democratic rule—if the right balance can be struck.

**Impact of the external reconstruction and development strategy**

There has been a shift in donor focus through the years and in relation to the development of the situation on the ground in BiH. In 2000, the 55 countries of the Peace Implementation Council presented an agenda for systematic state building.33 That was the starting point for a reform of state institutions and a first attempt at constitutional reform. Now post-conflict development is inextricably linked to EU accession and stability in the entire region of Southeast Europe. Many issues remain outstanding. Because the root causes that led to ethnic conflicts and war have never been resolved, festering animosities have weakened many implemented activities, causing their results to be disappointing. While international donor projects mobilized funds and resources with goals of ensuring reconstruction, development, and sustainable peace through stable institutions, none of the project engaged in a comprehensive social process leading to societal reconciliation.

After the war, no institutions existed that would have been able to implement reforms, so a large international presence was necessary at that time. Unfortunately, most donor programs were not implemented through domestic structures, which had a double negative impact. Because the BiH people were not allowed to serve in significant leadership roles or to be sufficiently involved in decision making, a lack of accountability and a lack of partnership between international organizations and BiH governmental institutions ensued. If BiH institutions had shared power and responsibility with international institutions, transparency on both sides could have developed, and the projects that were implemented would have been more productive.

**The Reform process’s impact on service delivery**

Keeping public institutions and the private sector under political control is a way of sustaining military efforts during war. In a case of protracted conflict, retaining this control is a way of sustaining political and economic power within the political elite in the post-conflict period. As wealth becomes a source of power, control over public-sector employment and state benefits are used to ensure support of relevant constituencies. Localization of power then ensures reinforcement of power in the hands of local elites, who can exert their influence without being disturbed by higher-level political involvement or the need to harmonize their actions with those of others.

Political power in Bosnia is not dependent on formal constitutional authority. Rather, it is contained within parties that control public institutions, state-owned enterprises, and security and intelligence forces.34 In this milieu, it is not surprising that allowing one’s power to be usurped

34 Cox, 2001,”State Building and Post-Conflict Reconstruction: Lessons from Bosnia.”
by higher levels of authority is perceived as a loss of control. It is in the best interests of local elites to keep constitutional structures weak and political and economic power localized.

In BiH, constitutional reform is an important precondition for development. At this time, the impacts of the political setup and governance solutions are difficult to estimate in terms of money spent, reforms delayed, citizen dissatisfaction, and lack of progress in the EU accession. However, another major factor contributing to the overall bleak situation in the public sector is the impact of the decentralization of state decision making on service delivery.

The ability of the state’s institutions to function effectively remains very low. BiH’s institutions rely on external support and are unable to cope with the double task of post-war reconstruction and integration into the global market. Multiple, mainly internationally funded and led projects for the improvement of service delivery at all levels of authority are underway. The UNDP, USAID, and OSCE are leading major initiatives for improvement of service delivery, particularly at the municipal level. Yet, these similar projects lack coordination and once they are completed often do not have lasting value or long-term positive effects.\(^\text{35}\) Perhaps a reason why these internationally-led projects fail is that they propose largely the same improvements, which often have not been adapted to local circumstances, including the sizes and needs of municipalities. BiH civil servants are involved in these projects’ implementation but not in their design phase. If local people could be included as equal partners in designing and planning such projects, they would share ownership of the process, and the reforms would be implemented more effectively with more positive, long-term effects.

The relative positions of state institutions, the international community, and citizens in relation to the reform process have also had major effects on the quality of service delivery. Generally, the quality of service delivery is poor because civil service employment has not been based on merit but on personal connections and because civil servants have learned that as individuals the quality of their work does not make a difference. Also, civil servants do not believe they need to perform their jobs well because they have observed that the IC is the final arbiter for all relevant decisions and the domestic institutions that employ them have little power.

Therefore, three factors related to negative impacts on the reform process can be identified:

- the decentralization that empowered local elites has led to inefficiency and corruption,
- the international community’s uncoordinated efforts have not sufficiently strengthened local governance, and
- reform programs designed by foreigners who do not engage local people as partners in the planning and design process continually fail because BiH civil servants do not believe that the programs they are expected to implement are relevant to the needs of the populations the programs are supposed to serve. Civil servants are often incompetent because they were hired through personal connections instead of merit and do not have to perform well to keep their jobs. And those who might be inclined to work harder to deliver high-quality services choose not do so because they have observed that whatever they do as individuals does not make a difference.

Mechanisms for citizen participation in post-conflict development

Citizen demands for accountability and service delivery

The citizens of BiH have not pressured the government for more efficient service delivery and greater involvement in the reform process. Sporadic attempts by civil society organizations and workers’ strikes have not had significant effects on either service delivery or government policies. On the contrary, they have demonstrated how little can be accomplished through public protest and invocation of rights in the country.

There are several reasons why ordinary citizens in Bosnia do not insist that they be consulted for input into the reform process and do not demand better delivery of services. First, the war left most citizens without the basic means of survival. During the war, they spent their savings on expensive commodities, and many people were forced to flee from their homes with no means to carry their belongings with them. Allowing local elites to exercise power created a state in which those who found employment or alternative sources of income were satisfied merely to subsist, and those who did not have jobs concentrated their energies on finding employment to ensure their own and their families’ survival.

Second, the international community soon took over the reconstruction process. BiH citizens perceived the international organizations as the real owners of development and as accountable for progress. Domestic authorities were not considered fully in charge of the future of the country and hence were not held accountable for the poor economic situation, the lack of jobs, and institutional instability and ineffectiveness.

Third, a comprehensive reconciliation process never took place. Identification with an ethnic group, spurred by wartime grievances, fortified societal divisions and enabled politicians to manipulate the people to fulfill nationalist agendas. For many in BiH, the wish to retaliate against wartime enemies overcame the wish to ensure better lives for themselves and their families. And fourth, the citizens who tried to create a civil society sector and its activities also negatively impacted citizens’ faith in their potential to change government behavior through civic activism, which was unknown in the pre-war Bosnian society in its contemporary form.

Civil society organizations – peacebuilders or a profit sector?

The treatment of peacebuilders and the position of civil society affect and even reflect the stability in a country.36 The civil society sector is well placed to offer services to socially excluded groups, head reconciliation initiatives and contribute to the overall peacebuilding process by bringing people together and organizing “cross-boundary” activities. It has thus had, by nature of its activities, a peacebuilding role in Bosnia.

In parallel to recognizing its peacebuilding and democratization role, Bosnian civil society needs to be observed from a critical side, too. Namely, efforts at coordinating the sector’s activities are still largely missing and the situation somehow resembles the lack of coordinated endeavor by the international community. An additional problem is sustainability.

The number of active non-governmental organizations (NGOs) and foundations in the country is estimated at approx. 4,500.37 The NGO sector employs 2.3% of the working population. It is estimated that 29% of total population receives services provided by these

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organizations and in 40% of municipalities in the country there is no competition, i.e. if an NGO did not exist, there would be nobody else to provide the same services.\textsuperscript{38}

The role of civil society organizations has from the end of the war until now been mainly to implement externally funded projects. The sustainability of organizations and associations has mainly depended on these external (largely foreign) sources of finance, while public sector financing remains low. A major consequence of this has been that projects are mainly tailored in a way to accommodate application requirements, put forward proposals that have the greatest chance of being funded and adapt the vision and mission of the organization as need (i.e. funding) arises.

However, at the same time, NGOs are considered to be centers of knowledge and skills when it comes to fundraising, budgeting, financial management in line with EU requirements, and project management, monitoring and evaluation.\textsuperscript{39} Leaders of these organizations are often referred to as the “NGO mafia” for their close circles of trust and networking when it comes to applying for tenders and other forms of fundraising. These skills could be better employed for developmental purposes.

Non-governmental organizations should shift their role from being service providers that rely heavily on foreign donor support\textsuperscript{40} to the initiators of active citizenry and a driving force of change based on public opinion. The time for this is ripe. Foreign funding is dwindling and only those organizations that have come up with self-sustainable activities have a chance of survival. Their agenda should focus on civic engagement projects and inclusion of civil society in the developmental and peace building agenda. For this, they will need strong support of the state by way of recognizing their inevitable role in peacebuilding and creating an environment in which their work is respected.

The Role of Foreign Actors in Bosnia and Herzegovina

The United States

The Western Balkan region and particularly the situation in BiH were at the heart of the Clinton administration's foreign policy – both during and after the war. During his first election campaign, President Clinton stressed that once he became president of the United States he would make it a priority to deal with the crisis in the former Yugoslavia and end the war in BiH. In essence, President Clinton kept his promise. The first step in resolving the armed conflict was US mediation between the Croat and Bosniak warring factions. The first peace conference was held in January 1994 in Bonn, where the Germans failed to end the conflict between Croats and Bosniaks. In March 1994, the US administration made a determined intervention, which resulted in the signing of the Washington agreement to create a Federation of Bosnia and Herzegovina as that part of BiH in which Croats and Bosniaks were the constitutive peoples. This agreement constituted the FBiH as an entity made up of 10 cantons. After the Washington agreement between the Bosniaks and Croats was signed in March 1994, a new BiH government was created, with Haris Silajdzic (the current leader of the Party for BiH) as Prime Minister and Jadranko Prlić, then prime Minister of the Croatian Community of Herzeg-Bosna, who is currently on trial at The Hague, as Minister of Defence.

\textsuperscript{38} Ibid.
\textsuperscript{39} Ibid.
\textsuperscript{40} Gagnon, 2002.
The United States next direct intervention with regard to BiH was to cooperate with France and Great Britain to end the conflict throughout the territory of BiH. After the then political and military leadership of the RS refused the US-proposed solution to end the war, military intervention followed involving the combined military forces of the United States, France, and Britain bombing military targets on the territory under the control of the Bosnian Serbs. Following this intervention (August 1995), politicians from BiH, Croatia, and Serbia initiated a peace agreement in November 1995 at Dayton, signing it officially in December 1995 in Paris, in which they agreed to end armed conflict in BiH and establish BiH as an internationally recognized state comprising two equal entities. The train of events during this period made clear that the war in BiH would not have been ended without the direct involvement of the United States.

During the second Clinton term, the United States remained strongly engaged in BiH, particularly in respect of military, security, and technical assistance. During the first phase of economic recovery, the US donated significant financial resources. After the end of Clinton's mandate and with the beginning of the Bush administration, the US presence in BiH reduced significantly, particularly after 9/11. The American administration refocused its foreign policy on the war against terrorism and on operations in Iraq and Afghanistan. During the first two years of the Bush regime, the parties which had previously been in opposition won the elections, forming an Alliance for Change, led by the largest multiethnic party in the country – the Social Democratic Party of BiH (SDP). The coalition led by the SDP achieved significant political successes during its two years in government (2000-2002), including membership of the Council of Europe and signing the Roadmap to European Union membership, as well as good economic performance (GDP growth based on investment in the business sector, the construction of the first sections of the Vc corridor highway).

The most recent American administration has displayed an important shift in foreign policy towards the Western Balkans, with a return of BiH to the priority list in American foreign policy in this part of the world. The rather distant approach of the Bush administration to BiH strengthened the position of the predominantly nationalist currents, as well as reinforcing the political programme of dividing BiH into three (ethnic) territories. This political rhetoric, which has unfortunately been stoked by the nominally social democrat but essentially ethnic party of Milorad Dodik (the SNSD –the Union of Independent Social Democrats, the dominant party in the RS), contributed to the institutional weakening of BiH and its loss of credibility with partners in Europe and the rest of the world. For precisely these reasons, the Obama administration has once again intervened decisively to deal with the gathering political crisis in BiH, which has prevented the country from attaining its significant economic potential and embarking on a path of economic and social development. The announced visit of American Vice President Joseph Biden to BiH in May 2009 confirmed the restoration of BiH to the focus of US foreign policy.

**The European Union**

The United States' key coalition partners in dealing with the war in BiH were France and Britain (military intervention in 1995), joined later by Germany, Italy, and the other EU member countries. Expansion to the east was a priority for the EU. BiH has already integrated with the EU in certain areas of the economy (e.g. banking). The country's geographic position makes it a natural crossroads linking Central Europe with the Adriatic and Western Europe with the East. Its potential for the generation of electrical energy and other alternative sources of energy is
significant for the Western Balkan region, as well as for foreign direct investors from Western Europe. The country has been historically linked with Western Europe since its transfer to Austro-Hungarian government by decision of the Berlin Congress (1878). The economic connections established with Western European companies, particularly from Germany, under the second Yugoslavia (1945-1990) were particularly significant and played a key role in the growth of the metalworking industry and the engineering expertise that developed along with the sector.

The EU has, between 2000 and the present, shown very considerable interest in integrating BiH within its membership. Of the three reform packages mentioned in the next part of this chapter, the second and the third related to meeting conditions for signing the Stabilization and Association Agreement (SAA). The EU continues to work very closely with the BiH authorities to accelerate the process of meeting the conditions arising from the SAA. Most of BiH's foreign trade takes place with EU member states (more than 60%). More than 65% of foreign direct investment in the country is from EU member states.

**Croatia and Serbia**

Croatia and Serbia are BiH's neighbors. During the war in BiH both countries played an active role in financing the Bosnian Croat and Bosnian Serb military formations. The official policies conducted by Slobodan Milosevic (the then President of Serbia) and Franjo Tudjman (the President of Croatia from 1990-1998) were based on expansionist nationalist programs to extend the borders of Serbia and Croatia into BiH and so divide the country between them. In a television interview given to TV Sarajevo in 1991, the Croatian president of the time Franjo Tudjman stated that the greatest historical achievement in political and administrative organization on the territory of Yugoslavia was the Cvetkovic-Macek pact. This agreement was signed during the period of the first Yugoslavia (the Kingdom of Yugoslavia) in 1939 and divided BiH into two parts: one part under the territorial sovereignty of Croatia (the western part of BiH), the other (eastern) part belonging to Serbia. This division was done away with under the new constitution of the second Yugoslavia (the Socialist Federal Republic of Yugoslavia) which comprised six equal republics, whose territorial integrity was guaranteed, as was that of each of the constitutive peoples within the republics.

The nationalist policies of Croatia and Serbia under these two presidents (Milosevic was indicted for war crimes on the territory of the former Yugoslavia and died at The Hague while on trial; Tudjman died in 1998) left deep scars on relations within BiH. After the death of President Tudjman, Stipe Mesic was elected to the office. This Croatian politician (President of Croatia from 1999 to 2009) had resigned from the HDZ in 1993 during the war in BiH precisely because of Tudjman's policy towards BiH (territorial claims and the treatment of Bosnian Croats). President Mesic's political views were very important for the establishment of a healthier basis for Croatian policy towards BiH that respected the territorial integrity of BiH. President Mesic also helped significantly to reduce pressure by nationalist political parties from Croatia on attitudes towards BiH and to shape Croatia's path towards Europe. The party currently in power in Croatia, the HDZ during the leadership of the former Prime Minister Ivo Sanader, was burdened by multiple unresolved personal conflicts between founding or early members (1990) and those who have in the meantime taken over the leadership of the party, including Mr. Sanader himself. The development of a European identity for Croatia and meeting the conditions for EU membership, including handing over individuals accused of war crimes, is a priority for
Croatian officialdom, but certain nationalist circles still exert pressure regarding policy towards BiH, particularly through the economic and trade lobbies. In 2010, Mr. Ivo Josipovic won the presidential elections in Croatia. His visits to neighboring countries (BiH and Serbia) and public appearances in the first year after the election show more constructive Croatian policy towards BiH and the region as a whole.

The transfer of Slobodan Milosevic to the International Criminal Tribunal for the former Yugoslavia at The Hague on 5 October 2000 marked a particularly important political shift in neighboring Serbia. The make-up of Prime Minister Zoran Dindic’s new government sent positive signals regarding healthier and more correct political relations with BiH, similar to those sent by the composition of the government in Croatia led by the Croatian SDP and Prime Minister Ivica Racan (2000-2004). Unfortunately, the political response of the Serbian underground and nationalist circles within Serbia was swift and brutal. Prime Minister Dindic was assassinated in Belgrade in March 2003 for handing over Milosevic to the court at The Hague and because of his pro-European political views. The Democratic Party, whose leader Dindic had been, underwent important changes. The most important politician in Serbia between 2003 and 2007 was Vojislav Kostunica, whose political program was essentially no different from that of Milosevic. Boris Tadic's victory in the 2008 presidential elections marked a turning point for Serbia and to some degree for the entire Western Balkans. His pro-European views are clear and have already yielded positive results. On the other hand, certain of his statements regarding Milorad Dodik’s nationalist rhetoric have failed to make unambiguously clear that such rhetoric has no place in dealing with problems in BiH.

Over the past two years, visits to Banja Luka (the capital city of the RS) by prominent politicians from the Milosevic era have become increasingly frequent. A visit to Banja Luka and the leaders of the SNSD by Dobrica Cosic, a well-known Serbian writer and first president of the Federal Republic of Yugoslavia (Serbia and Montenegro), which provided the occasion for a well publicized statement and the promotion of ideas first put forward by circles close to the SANU (Serbian Academy of Arts and Sciences) and which provided the intellectual basis for promoting the greater Serbia project during the period of the disintegration of the SFRY (1991/1992), was neither encouraging nor contributed to the institutional stability of BiH. While these are not official visits by the Serbian authorities, it would be a major step forward if the Serbian political establishment were clearly to distance itself from such ideas and their promotion by certain influential politicians in the RS. Similarly, dealing with certain economic problems related to trade (essentially discriminatory treatment of producers) and to the power sector would result in significant concrete and very specific measures towards establishing long-term stable political and economic relations between these neighboring countries.

Potential for renewed violence

In order to assess the likelihood for renewed overt violence, an analysis needs to be conducted in a context of security, political, economic and social factors that bear risk for concrete situations in which a new war would become reality. In the Bosnian context, security-related risks are least poignant. Despite the fact that the unified armed forces still have a fragmented command structure and that police reform has not been implemented, general crime rates are on the decline. A system for destruction and moratorium on export of small arms and light weapons

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(SALW) has been established, and in 2007, 2,100 tons of weapons were destroyed. Late 2008 and early 2009 were marked by rumors about the rearming of informal factions through the police, hunting associations, and private security companies. However, if this has occurred, it has not jeopardized stability.

Most risks can be identified in relation to the political situation. While political parties are gaining points from voters based on promises of maintaining Dayton-imposed solutions, their continuing lack of serious dedication to reform is resulting in diminishing interest in providing assistance by the IC. It has become clear that the presence of the IC is vital for maintaining stability; therefore, its sudden withdrawal could empower local politicians to practice politics that would lead to solutions detrimental to the country’s future.

Conversely, should the IC – exasperated by the lack of will on the side of domestic actors – decide to impose solutions, for example, by requiring constitutional reform, resistance could be expected. An IC attempt to impose solutions in police reform in late 2007 made this very clear. Following a set of procedural changes in the police reform imposed by the High Representative, state institutions were de facto blocked, and a majority of Republika Srpska (RS) officials threatened to withdraw permanently from state-level governmental structures. The prime minister (an SNSD official) temporarily resigned with the clear message that BiH will not allow the IC to rule over the country.

As for economic factors, it is clear that the state is incapable of mitigating the effects of the global economic downturn that is further undermining BiH’s already shattered, weak economy. Even in more developed countries, it is widely known that a reduced standard of living and increased unemployment can lead to instability and to a revival of social disagreements. Economic crises also can lead to increased levels of organized and financial crimes. A combination of these factors in BiH could trigger both state collapse and renewed ethnic grievances. It is likely that the European Union, the United States, and other governments actively involved in the Bosnian peace process could become increasingly absorbed by efforts to reduce the effects of the economic crisis in their respective countries. Faced with insurmountable obstacles and lack of effective leadership, state institutions in BiH could collapse.

A major social factor that could culminate in overt violence is the instability of Bosniak-Croat communities. The largest Bosniak-Croat community is Mostar, a southern city that was divided between the Bosniak east and Croat west during the war, which is still a highly unstable community. Between June 2006 and November 2008, in street fights between Bosniak and Croat youth, one person was killed, several wounded, and more than 30 police officers were injured. Police managed to prevent an ethnically motivated mass fight between high-school students in late 2008 that could have had major consequences.

Importantly, these risks are rather low in terms of escalation potential, mainly due to the extensive international presence. However, they do need to be constantly monitored.

MACROECONOMIC POLICY AND ITS IMPACT ON PEACE AND STABILITY

The economic dimension of pre-war and post-war Bosnia

Economic conditions in BiH before the war

BiH was one of the three pre-war Yugoslav republics that individually had a positive trade balance between 1985 and 1991. More precisely, three of the five largest exporters in the former Yugoslavia were from BiH: Energoinvest Sarajevo, a producer of electrical equipment, engineering, oil refining, and producer of petroleum derivatives, metallurgy, clay and aluminum, and Unis Sarajevo, which was active in the auto and military industries, and in metallurgy. During the 1980s, the largest automobile factory in the Balkans was located in Sarajevo (in 1990, its annual production was 32,000 Golf cars) as a result of a joint venture by Volkswagen and Unis (TAS – The Sarajevo Car Factory). It was also very important for BiH’s pre-war economic development that Sarajevo hosted the 14th Winter Olympic Games in 1984 and that between 1978 and 1984, approximately US$1 billion was invested in the development of winter and rural tourism, while the city infrastructure in Sarajevo was fully overhauled. Agriculture and the food industry also saw significant progress, and before the war, BiH was home to a number of successful food and beverage producers (UPI Sarajevo, Bosanka Doboj, and Vitaminka Banja Luka).

Basic characteristics of the post-conflict economic situation in BiH – human and physical capital loss

BiH did not attain international economic recognition until the end of the war, with memberships in the International Monetary Fund (IMF) in December 1995 and the World Bank (WB) in March 1996. When BiH gained membership in the World Bank, high-priority reconstruction and renewal programs began.

The postwar economic situation in BiH has been plagued by numerous conflicting goals, which should have been attained relatively quickly after the end of the most important war-related disaster in Europe since World War II. This fact has severely affected the dynamics of economic growth and the equilibrium of the labor market. The war, from 1992 through 1995, was particularly devastating in terms of the death toll and high numbers of missing persons. The loss of lives from death and displacement severely affected the quantity and quality of human capital, as well as infrastructure and industrial/commercial property. BiH’s economic recovery was entirely dependent on resources authorized by the international community’s donor conferences. The degree of wartime devastation, from 1992 through 1995, is illustrated by the following indicators:

- The total number of recorded deaths from 1992 to 1995 was 102,622;\(^{44}\)
- The number of missing persons still being sought is around 20,000;\(^{45}\)
- The number of people who fled because of the war and have not returned is approximately 500,000\(^{46}\);


\(^{45}\) Cekic, Smail, Ibid, p. 89.

\(^{46}\) http://www.camo.ch/dijaspora_bih.htm
• The extent of war-time damage to personal and business assets only in Sarajevo Canton is estimated on EUR 14 billion, and
• The total gross domestic product (GDP) losses over the four-year period amounted to about US$30.4 billion (the pre-war GDP of BiH was approximately US$10.3 billion in 1991 US$ terms and average GDP during the war was estimated US$1.2 billion).

And after the war, from 1996 through 2008, according to the United Nations High Commissioner for Refugees (UNHCR), 1,026,692 people returned in total, but only 467,297 returned to their places of origin. In 2008 there were approximately 124,529 displaced persons: 55,894 in the FBiH, 67,523 in the RS, and 1,112 in Brcko District.

The GDP of BiH was greatly reduced by extensive war-related destruction. At the end of the war in 1995, the IMF and the World Bank estimated BiH’s GDP to be some US$1.2 billion at the current rate. Particularly important for analysis of the impact of the war on the economy is the drop in the population from 4.45 million in 1991 to an estimated 3.35 million in 1995. Between 1996 and 2008, the population rose to 3.84 million.

Donor assistance and post-war economic recovery

Between 1996 and 2000, financial resources were largely channeled into the reconstruction of housing, infrastructure, and public services. Resources available for business-sector development were much more modest and limited in scope.

Table 1: Distribution of Donor Assistance to BiH Coordinated by the World Bank (1996–2000)

<table>
<thead>
<tr>
<th>Sectors</th>
<th>Shares (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Housing construction</td>
<td>16.1</td>
</tr>
<tr>
<td>Electricity production and transmission</td>
<td>13.0</td>
</tr>
<tr>
<td>Transport infrastructure</td>
<td>11.2</td>
</tr>
<tr>
<td>Credit lines to business sector</td>
<td>8.2</td>
</tr>
<tr>
<td>Water supply</td>
<td>7.8</td>
</tr>
<tr>
<td>Social security support</td>
<td>6.8</td>
</tr>
<tr>
<td>Foreign debt repayment</td>
<td>4.4</td>
</tr>
<tr>
<td>Education</td>
<td>4.3</td>
</tr>
<tr>
<td>Capacity building of state institutions</td>
<td>3.9</td>
</tr>
</tbody>
</table>

Table 2. Gross domestic product – Bosnia and Herzegovina (1991–2000)

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP in millions of KM (local currency – current prices)</th>
<th>GDP in millions of US$ (current prices)</th>
<th>GDP per capita in US$ (current prices)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>17,750</td>
<td>10,250</td>
<td>2,305</td>
</tr>
<tr>
<td>1996</td>
<td>4,192</td>
<td>2,786</td>
<td>670</td>
</tr>
<tr>
<td>1998</td>
<td>7,650</td>
<td>4,343</td>
<td>1,189</td>
</tr>
<tr>
<td>2000</td>
<td>9,611</td>
<td>4,536</td>
<td>1,200</td>
</tr>
</tbody>
</table>


Table 2 shows that BiH’s GDP rose from US$2.79 to US$4.54 billion between 1996 and 2000 in current prices. That GDP grew by a factor of 1.63 over this period was largely due to the high-priority renewal and reconstruction program coordinated and implemented by the World Bank. During the period in question, according to the World Bank Mission to BiH, some KM5.3 billion (the local currency was convertible marks, domestically designated as KM and internationally as BAM) or US$3.5 billion were spent on the reconstruction of basic infrastructure, housing, and educational and health care institutions.

Regulatory and legal reforms to achieve a single economic space in Bosnia and Herzegovina

Strategies and objectives of BiH regulatory reforms in economy were defined primarily by the international community representatives based on the provisions of the Dayton Peace Accords, and then based on the definition of BiH strategy for fulfilling prerequisites for signing the Stabilization and Accession Agreement with the European Union (EU). Through the Peace Implementation Council (PIC), Office of the High Representative (OHR), European Commission (EC), as well as through resident missions of the World Bank (WB) and the International Monetary Fund (IMF), and with a more or less successful cooperation with the Council of Ministers of BH (CoM - the state level government), governments of FBH and RS, and Brcko District (BD) after its establishment (according to the International Arbitrage Decision in 2000), the international community representatives were setting priorities in the implementation of economic reforms.
The first package of reforms (1997-1998)

The first international community package called *Quick Start Package (1997)* set the priorities in economic reforms, the basis of which was made up of the following laws on BiH (state) level:

- Law on Central Bank of Bosnia and Herzegovina
- Law on Foreign Trade Policy of Bosnia and Herzegovina
- Law on External Debt of Bosnia and Herzegovina
- Law on Single Bases for Customs Policy
- Law on Customs Tariffs of Bosnia and Herzegovina
- Law on Foreign Direct Investment Policy in Bosnia and Herzegovina.

This reform laws package was developed in legal departments of the OHR and sent to the CoM, who were to discuss the proposals of laws and propose their enactment to the Parliamentary Assembly of Bosnia and Herzegovina. The enactment of these laws by the BiH state-level institutions also implied their ratification by the Parliament of FBH and RS National Assembly. Most listed laws were enacted during 1997, while the Law on Foreign Direct Investment Policy was published in the Official Journal of BiH in 1998, and was ratified in the Parliament of FBH in 2001 and the National Assembly of RS in 2002. A Law on External Debt was also enacted in 1998.

The Quick Start Package provided the legal basis for establishing the fundamental state-level institutions necessary for the economy to function. Owing to the enactment of the Law on Central Bank of Bosnia and Herzegovina (CBBH), the Central Bank was established in August 1997. The establishment of this institution was extremely significant both for the integration of financial flows in BiH and for creating basic elements of tracking financial transactions on the entire BiH territory. Also, this institution was very significant ground for starting the organized struggle against crime, i.e. for the control over financial transactions. Before the CBBH was established, there had been four currencies circulating in BH, only one of them (German mark) being used in all parts of BiH. Most transactions in the parts of BiH where Bosniaks prevailed had been denominated in Bosnian Dinar (introduced in August 1994), while the regions where Serbs prevailed used mostly Yugoslav Dinar (the national currency of the Federal Republic Yugoslavia at that time), and regions with Croatian majority used Croatian kuna (the national currency of neighboring Croatia). Introduction of a single BiH currency into cash operations in June 1998 was followed by the definite acceptance of a single currency on the entire BH territory in cashless transactions as well in September 1999. Thus, it was only in the last quarter of 1999 that a single BH currency was finally accepted as the only means of payment in transaction across BH.


The second package of reform laws was determined in the cooperation with the EU (European Commission – EC). These were the guidelines named BiH Roadmap Toward the European Union. The roadmap was presented by the representatives of the EC in BiH in the first half of 2000, and it included reforms in three areas:

1. A regulatory framework for changes in the structure of political system;
2. A reform of regulatory system in the fields of democracy, human rights, and the rule of law; and
3. A regulatory framework of the Roadmap for the reform of BiH economic system.

The regulatory framework of the Roadmap for economic system reform resulted in the successful reform of the internal payment system. In the 1995-2000 period, the internal payments had not been unified – they were carried out through three virtually national/ethnic institutions: in the regions where Bosniak population was the majority, payments were carried out by the Payment Bureau of FBiH, in regions where Croatian population prevailed, payments were carried out by the Payment Bureau of FBiH headquartered in Mostar, and in the RS entity, the relevant institution was the Payment Office of RS. With the intense technical aid by USAID and the EC support, payment bureaus were closed and starting from January 5th, 2001 the entire system of internal payments was transferred to commercial banks. *BiH thus became the first country in transition where this reform was implemented.* Foundations for the implementation of the internal payments reform were laid in the preceding period, by introducing a single BiH currency in cashless payment transactions.

Establishment of BiH Treasury was achieved within the CoM and together with the establishment of State Border Service of BH (founded in the second half of 2000), establishment of BiH Treasury was a step ahead in the gradual laying of bases for the BiH fiscal system reform, which ensued in the third stage of reforms. The BiH Institute of Standardization and Measurement was also established. However, its activities in the first years of operation were very limited as opposed to the previously described reforms in the financial sector. A Law on Competition and a Law on Consumer Protection were also adopted, but their implementation is still very limited.

*The third package (2003-2008)*

The third stage of reforms started with the signing of the Memorandum of Understanding and preparation of Feasibility Study of BiH accession to the EU (last quarter of 2003). This study identified the necessary reforms in sixteen areas as preconditions for signing the Stabilization and Association Agreement (SAA). Although all the sixteen areas are important for efficient functioning of BiH economy, the most important economic system reforms out of the sixteen priorities pertained to the reform of fiscal system (customs and tax system), adjusting budget practice to European legislation and adjusting trade policy to European standards.

The period from early 2004 to the end of first quarter of 2006 witnessed very significant shifts in the reform of institutions and systems for collecting and distributing indirect taxes. With the extensive financial and technical support by the EC the Indirect Tax Administration of Bosnia and Herzegovina (ITA) was established late in June of 2004. Thus, it was the first institution on the state level since the end of war that became authorized to collect and distribute fiscal revenues (customs, excises and value added tax), and to control the collection of this sort of tax revenues. This institutional establishment marked the end of existence for customs administrations of FBiH and RS, as well as DB, which employed 2,450 people. Initially, the ITA employed 750 people. By the end of 2006, the total number of employees had increased to 1,700, and to 2,200 over the subsequent two years.

In 2005, BiH Parliamentary Assembly enacted the Law on Value-Added Tax, the implementation of which started on January 1st, 2006. The value-added tax (VAT) has been a
better basis for struggle against illegal trade in goods and services, and has contributed to creating better grounds for the integration of BiH economic space. The fact that before the VAT was introduced there had been different sales tax rates in the two entities (20% and 10% in FBH, and 18% and 9% in RS), and that the BD authorities’ tax policy had been different from those in FBH and RS, was a very convenient basis for tax evasion and, particularly, for tax competition on the inter-entity level. The introduction of VAT allowed BiH authorities to run uniform fiscal policy for the first time after the war.

The fiscal structure of BiH and responsibility for financing public services

While BiH’s IMF and WB membership facilitated post-war reconstruction and rehabilitation, these international organizations also required clarification of the responsibilities for public revenue collection and for financing public services. Between 1996 and 2004, these two activities were based on the administrative structures set out in the Paris Peace Agreement.

The Federation of BiH

The fiscal structure of the FBiH was quite complicated, as were the Federation’s options for coordination and effective implementation. Until 2004, 85 percent of FBiH budgeted revenues came from three sources: customs, excises, and certain forms of corporate profit taxes. The federal budget covered spending on the FBiH Army; war-related disability pensions and payments to war widows and orphans; public administration, including the police and the specialized federal administrations; the FBiH’s share in Bosnia and Herzegovina’s foreign debt; and capital spending involving more than one canton or the FBiH as a whole.

The cantons also have their own budgets. Revenues from sales taxes and later from value-added taxes account for approximately 80 percent of cantons’ revenues; other sources are corporate taxes levied on companies not subject to corporate taxation on the level of the FBiH (corporate taxes on companies in telecommunications, electricity production, and financial services belong to the FBiH budget). The cantons also have major responsibilities for financing public services, particularly education. From 2000 to 2009, education accounted for some 40 percent of total spending at the cantonal level. This was followed by social protection (other than war-related disability payments), and cantonal administration.

Republic of Srpska

Budget revenues for the Republic of Srpska (RS) come from customs, excises, sales taxes, and corporate income taxes, which together make up 90 percent of total revenues. There are no cantons in the RS to share sales tax or value-added tax revenues. Between 1996 and 2004, the most important public services financed from the RS budget were the RS army and police force, war-related disability payments, social protection payments other than pensions and unemployment benefits, education (though primary and secondary education are co-funded in the more developed municipalities), capital spending/infrastructural investment, and the entity-level bureaucracy, including specialized administrative units.

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52 Between 1996 and 2004, there were two official armies in BiH, one in each entity, which constituted a major internal contradiction and potential cause of renewed conflict. They were paid for by the entities.
The burden represented by social protection for war victims is best illustrated through numbers. In mid-2008, there were 169,929 disabled war victims in the FBiH, compared to 65,184 in the RS, a ratio of 72.3 percent to 27.7 percent. The population ratio is 63.2 percent to 36.6 percent; the remaining 0.2 percent of the people are in the Brcko District. Population divisions resulted from the nature of the war in BiH. The towns of Sarajevo, Mostar, Zenica, Bihac, Gorazde, Srebrenica, Tuzla, Tesanj, and Maglaj suffered prolonged sieges. More than 80 percent of veterans or civilians with war-related disabilities in the FBiH are from these towns or cities. All except Srebrenica remained within the FBiH under the postwar settlement.

In 2000, the International Arbitration Commission established Brcko District (BD) as a separate district with its own budget, financing the same functions and services as the cantonal and municipal budgets within the FBiH. Between 2000 and 2004, BD revenues came from the same sources that in the RS belonged to the entity level, including customs levied at the Brcko international border crossing.

A major paradox in the fiscal structure of the country between 2000 and 2003 was that the entire state budget for BiH was less than that of BD: KM195 million (EUR 100 million) on average for BiH compared with KM210 million (EUR 107 million) for BD. In fact, before 2005, the state level was entirely financed by transfers from the entity budgets, with no practical scope for active development or economic policy and no authority for fiscal policy until mid-2004.

Changes to fiscal structures and public financing

Fiscal reform pushed under BiH’s EU Accession process saw responsibilities for collecting and allocating indirect taxes transferred to the state level, the Indirect Tax Authority. Defense reform led to the replacement of twin official military structures during 2005 and 2006 by a single defense system (the Armed Forces of BiH and a state-level Ministry of Defense), funded via the BiH Council of Ministers.

Defense, indirect taxation, and border control reforms sharply increased the state-level budget and the scope within the entity budgets for financing capital projects in cooperation with international financial institutions. Between 2006 and 2008, the state-level budget averaged KM1 billion (EUR 511 million). Spending was concentrated in the Ministry of Foreign Affairs, the Ministry of Defense and the Armed Forces, the Indirect Taxation Authority, and the State Border Service. Strengthening state-level capacity by providing support to BiH’s military structures was expected to remove certain threats to security and stability and to help combat cross-border crime by supporting the State Border Service. According to Milante and Skaperdas’s paper in this volume, investments in institutional capacities of countries presented by an increase in $\sigma$ decreases the probability of new war and increases the probability for power sharing:

$\sigma$ can be considered a function of investments in governance and property rights ($\sigma(I)$) as well as other factors. In particular, it could depend on:

- On outside forces, good (third parties genuinely interested in Peace) or bad (third parties that have an interest in the continuation in conflict)
- The history of past interactions (the „capital“ in commitment and governance they have inherited from the past)

53 Papić, 2008, 265.
The actual choices of investment by the parties. Those, in turn, can be ordinary non-cooperative choices or closer to the socially optimal ones (which are higher than the noncooperative choices.)

In other words and according to Milante-Skaperdas model, defense reform in BiH entailed a significant reduction in spending on the military, with investment in entity and state-level institutional capacity (an increase in $\sigma$ according to the model) The professional corps was cut from more than 60,000 in 1997–1998 to fewer than 10,000, reducing related spending and allowing reallocation to social transfers and job creation for demobilized soldiers. This rebalancing was due largely to external actors interested in maintaining peace—NATO, the US, and the EU.

Table 4: BiH Fiscal balance as a percentage of GDP (consolidated budget at BiH level and social insurance funds)

<table>
<thead>
<tr>
<th>Year</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public revenues</td>
<td>47.2</td>
<td>46.7</td>
<td>45.9</td>
<td>44.6</td>
</tr>
<tr>
<td>Public expenditures</td>
<td>46.1</td>
<td>47.1</td>
<td>49.5</td>
<td>50.2</td>
</tr>
<tr>
<td>Fiscal balance</td>
<td>+ 1.1</td>
<td>- 0.3</td>
<td>- 3.6</td>
<td>- 5.7</td>
</tr>
</tbody>
</table>

Source: IMF, IMF Executive Board Concludes 2010 Article IV Consultation with Bosnia and Herzegovina, Public Information Notice (PIN) No. 10/154, December 3, 2010 (www.imf.org)

Thanks to EU pressure and fiscal reforms, BiH was in the black between 2003 and 2007. In 2008, there was a fiscal deficit, forcing the authorities to negotiate a Stand-by Agreement with the IMF for US$1.2 billion over the next three years, signed on May 5, 2009, conditional on cutting social transfers by KM414 million (EUR 212 million) in the FBiH and by KM146 million (EUR 75 million) in the RS, as these levels of social transfers were deemed too high. It is too soon to know what the comprehensive results of these reductions will be.

The monetary regime in BiH

Established in 1997, the Central Bank of BiH (CBBH) cannot carry out discretionary monetary policy and lacks the lender of last resort function. Local currency could be issued only if covered by foreign exchange reserves at 100 percent of all domestic currency in circulation plus commercial bank reserves held by the CBBH, which form the monetary base for BiH. For the first seven years of the central bank’s existence, the CBBH governor (its top official) was a foreigner, Peter Nicholl, with deputies from each of the three constitutive peoples. Given the political environment when the CBBH was created and its subsequent performance, the international community’s insistence that the CBBH not set discretionary monetary policy was logical. At the time when the CBBiH was being established, the political situation in BiH was still very unstable, with political parties exercising undue influence on decision-making with regard to key political and economic issues. The Dayton peace accords themselves stipulated that the CBBiH should take the form of a currency board and ruled out discretionary rights to create monetary policy. The main argument made by IMF experts to support their case that the CBBiH should be a currency board was that it would minimize political pressure on senior management.

at the Bank and prevent the governing parties from using inflationary financing to fund their economic programs. After 2005, a BiH citizen was appointed as Governor of the CBBiH and management of the Bank passed fully into local hands. There was, however, no change to the currency board arrangement, which proved a good basis for eliminating currency risk and related losses as the economy weathered external shocks caused by the global financial and economic crisis.

The currency was called the convertible mark (KM or BAM) and was introduced into circulation in June 1998 and used for non-cash transactions in late 1999. The CBBH Act stipulated a peg of 1 KM to 1 Deutschmark. Since 2001, the exchange rate has been 1 EUR = 1.95583 KM Arguments for a currency board peg showed their worth after the single currency was introduced for cashless transactions in BiH.\(^{55}\) This helped attract foreign investors, particularly in banking, but also in the trade and manufacturing sectors. In 2000, the first Western European bank, the Austrian Raiffeisen Bank, entered the market, buying a small but fast-growing domestic private bank (the Market Bank), followed by the Hypo-Alpe-Adria Bank (Austria), Hypo Vereinsbank (Germany), Volksbank (Austria), NLB (Slovenia), and later (2005–2008) UniCredit Bank, Banka Intesa, and the Erste Bank. By 2004, the banking system was largely under the control of foreign banks.\(^{56}\)

The commercial banks’ assets to GDP ratio has grown from 44 percent to 85 percent since 2000. BiH’s commercial banking practices are among the better organized in the Western Balkans, and BiH was the first country in transition to implement an internal payment system reform in the first quarter of 2001. The intensive development of commercial banking between 2000 and 2008 facilitated economic growth on two bases:

- Rapidly increased personal lending, stimulating consumer demand; and
- Gradually increased business lending.

**BiH trade policy**

Since the adoption of the Quick Start Package, trade policy has formally been a function of the state. However, until the Indirect Tax Authority was established in 2004, state-level authorities lacked concrete instruments to put trade policies into practice. In mid-2004 the authorities received a customs and excise policy, which became their tool kit and instruction manual for how to conduct trade according to the state’s policies. In the meantime, BiH signed free trade agreements under the Stability Pact for South Eastern Europe. The “Stability Pact for South Eastern Europe” was launched in 1999 as the first comprehensive conflict prevention strategy of the international community, aimed at strengthening the efforts of the countries of South Eastern Europe in fostering peace, democracy, respect for human rights and economic prosperity.\(^{57}\)

During the second phase of the reforms based on the Roadmap Toward the European Union (2000–2003), the country signed agreements with all the countries of Eastern Europe, including Turkey, which were replaced in late 2006 by a regional trade agreement, the Central European Free Trade Agreement (CEFTA). In June 2008, the EU Stabilization and Association Agreement was signed, liberalizing trade with EU member states.

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\(^{55}\) See Hanke, 1998; and Hanke, Jonung, and Schuler, 1993.

\(^{56}\) According to the European Bank for Reconstruction and Development (EBRD), 2008, nearly 94 percent of banking assets in BiH are controlled by banks owned by nonresidents, 110.

\(^{57}\) See www.stabilitypact.org/default.asp.
BiH’s foreign trade suffers from high trade and current account deficits, which are most marked with countries where the ethnic groups within BiH have special business and other interests: Croatia, Serbia, and increasingly Turkey. Imports from these countries are generally products for household consumption. Capital goods are more likely to come from Germany, Italy, and Austria. Since 2005, BiH’s most important trade partners have been Croatia, Germany, Serbia, Italy, and Slovenia with respective shares of 18.2 percent, 13.7 percent, 12.5 percent, 11.3 percent and 11.1 percent.

This pattern of trade reflects an unwillingness in BiH to promote manufacturing and local competitiveness, as well as the political elites’ involvement in trade, which has turned into a form of primitive accumulation and the creation of economic elite groups among all three peoples of BiH. These elite groups have successfully adapted to the principles of free trade, using the “free trade mantra” for profit. Easy private lending through commercial banking sector added fuel to this fire.58

The demography behind the deficits is very important: the deficit with Croatia is more than 80 percent due to trade with companies in the FBiH (mostly Bosnian Croat or Croatian); more than 85 percent of the deficit with Serbia arises in the RS (through Bosnian Serb or Serbian trading companies); the fastest growing trade deficit over the past three years has been with Turkey, largely via trading companies owned by Bosniaks or Turks.59

Trade liberalization with EU countries has removed customs, one of the main irrationalities of fiscal policy, as in the past Bosnian companies paid customs to import equipment, machinery, tools, semi-finished goods, raw materials, and components from EU countries, which clearly indicates that the capital goods sector needed to improve its competitiveness. Given the removal of customs on final products from South Eastern European countries, a very poorly defined excise policy allowed cigarettes, coffee, petroleum, and alcohol to be sold more cheaply in BiH than in their countries of origin. And regarding customs on capital goods, local producers faced an uneven playing field, particularly vis-à-vis Croatia, Serbia, and Turkey.

Foreign Direct Investment and the Bosnian economy

BiH’s main exports are in manufacturing. Foreign direct investment (FDI) in this sector has mostly but not exclusively been brown field; that is, foreign companies have purchased or leased existing production facilities to start new production. The Foreign Direct Investment Policy Act, part of the Quick Start Package at state level, allows non-residents to invest with 100 percent ownership in all branches of the economy except arms manufacture and military equipment, games of chance, and public media. Both entities exempt companies receiving foreign direct investment from corporate income taxes for five years in direct proportion to the percentage of foreign ownership; 100 percent foreign ownership means a 100 percent exemption. The FDI legislation applies almost entirely to investments at the entry level.

59 This problem of asymmetries in trade with neighboring countries was recognized as early as 1999 by experts at the World Bank and the European Commission: “Customs tariffs … For full harmonization of the customs system, the Entities must also eliminate their special trade arrangement with Croatia and Yugoslavia, which effectively exempts most imports from customs tariffs and subjects these commodities to domestic rather than foreign excise tax rates.” See World Bank and European Commission, 1999, 33.
The legal arrangements governing FDI and the parallel creation of institutions that marked the beginning of economic integration, for example, the CBBH, resulted initially (2000–2003) in relatively stronger FDI into commercial banks. In 2002–2008, FDI in wholesale and retail increased from Croatia in Konzum; from Slovenia in Mercator and Tus; from Serbia in Delta Holding; and from France in Interex. Tax incentives based on FDI and corporate income tax legislation meant financial and trading activities have headed the growth rate and GDP growth table since 2002. This FDI-based symbiosis of the financial sector and trade fed the widening trade deficit.

Between 1997 and 2005, foreign direct investors invested in manufacturing related to car parts. Fully or partly foreign-owned companies in the sector include three important actors: VW Vogosca Sarajevo, ASA Prevent Group, and PS Cimos TMD Gradacac. Between 2000 and 2007, the following companies received the most FDI: Arcelor Mittal Zenica (Zeljezara Zenica, that is, Zenica Steelworks) was purchased by Mittal Steel in 2004; Bosanski Brod oil refinery was purchased by the Russian oil company Zarubeznjeft; and the Birac company of Zvornik, which produces alumina, was bought by a Lithuanian investor.

Privatization and the concentration of economic power along ethnic lines

Privatization was a central pillar of the post-war economic program. By early 1997, legislation for privatization at the entity level, ignoring the state/federal level, had been written. Vouchers were allocated to adult members of the public so that they could buy shares in companies; certificates are pieces of paper that list the number of shares owned. All citizens of BiH of 18 years of age or more on March 31, 1992, received 100 index points for vouchers. They received a further ten points for each year of employment. The value of these index points was based on the total value of business assets reported in opening balance sheets on the 31st of December, 1998. The total value of the state capital represented in this way on the basis of normal accounting procedures was then divided by the total number of index points.60

Companies in the former Yugoslavia were not owned by the state; the term used to describe their ownership translates as “socially owned,” meaning privately owned, in that companies kept the revenues they earned. By 1990 and 1991, privatization had begun in all the former Yugoslav republics. In 1994, the wartime authorities passed a law converting social (private) property into state-owned property. Post-war privatization took place at the entity level using a system of vouchers. All property seized by the state during the war was for sale. Properties were divided into shares, and certificates were issued. Individuals and groups bought shares using their vouchers and were given certificates showing the number of shares owned. As this was an entity matter (the Dayton Agreement defines the Federation of Bosnia and Herzegovina (FBiH) as the Bosniak and Croat entity and the Republika Srpska (RS) as the Serb entity), the privatization process transferred ownership of property worth approximately KM10 billion with no inflow of fresh capital. Even worse, it effectively legalized the principle of ethnic privatization. The legislation in both entities allowed members of the majority ethnic group in a given area to use their vouchers to become exclusive owners of a given company. In contrast, privatization by tender requires a privatization contract with provisions calling for partial payment in cash, the introduction of new equipment and technology, resolution of employee issues, and development of business activities and marketing channels.

Results have shown that tender-privatized companies bought by solid investors from Western Europe or elsewhere have helped integrate the BiH economy, while voucher privatization simply reinforced entrenched ethnic, administrative, and political divisions.

Growth rates, economic performance, and key barriers to development

During the first four-year period after the war, from 1996 through 1999, economic growth was fostered by the Priority Reconstruction Program, funded by grants and loans from the World Bank’s International Development Association (IDA) and International Bank for Reconstruction and Development (IBRD). Politicians in power at the time have referred to this as a period of particularly high growth. However, BiH growth rates of 85 percent, 61 percent, and 14 percent for 1996, 1997, and 1998, respectively, were hardly surprising, given that BiH’s GDP in 1996 of US$2.7 billion was approximately 27 percent of the 1991 GDP (which was US$10.3 billion).61

Since 2000, BiH’s overall growth has come less from the Priority Reconstruction Program than from private-sector job creation, thanks to privatization, an environment favorable to FDI, and domestic investment in export-oriented or import-substituting projects. BiH’s first period of post-war economic growth, from 1996 through 1999, was financed primarily by donations coordinated under the Priority Reconstruction Program led by the World Bank. From 2000 through 2003, the economy grew largely in its banking and trade sectors. And since 2004, substantial growth in production has been based on FDI in manufacturing, along with continuing growth of FDI in banking, and trade.

Given that the Dayton Agreement’s requirements had adverse effects on BiH’s macroeconomic policy and created many institutional barriers to business development, the country’s business sector has achieved relatively good results. BiH’s rate of economic growth has improved to the point that it was one of the 13 fastest-growing economies between 1998 and 200462. Between 2000 and 2007, BiH had the 23rd fastest-growing economy in the world, as its growth rate had slowed relative to most of Central and South Eastern Europe.63

The following table presents economic growth rates for the group of case-study countries studied in this volume. Economic growth is based on the wealth coefficient introduced by Causevic.64

The wealth coefficient (Cw) is the ratio between the country’s percentage share of world GDP for a given year and its percentage share of world population for the same year or:

\[
Cw = \frac{\left(\frac{GDP_{cx}}{GDP_w}\right)}{\left(\frac{POP_{cx}}{POP_w}\right)}
\]

where:
- GDP_{cx} – GDP country X
- GDP_w – GDP world
- POP_{cx} – Population country X
- POP_w – Population world

This coefficient corresponds in its final ranking to the rankings given by GDP per capita, but it is more representative for the purposes of this analysis, as the information it contains shows to what

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61 The European Commission and the World Bank, Ibid. p.47.
64 Causevic, 2006.
degree a given country or economy’s share in world GDP is greater or less than its share in world population. An additional reason for constructing this coefficient, as a means for drawing conclusions regarding the speed and direction of change in economic prosperity, is that comparison of GDP per capita over longer periods does not allow conclusions about the growth or decline in a country's relative economic importance vis-à-vis the world economy, which use of Cw does allow.

Taking Sudan as an example of calculating the wealth coefficient for 2007, we can calculate the coefficient in the following way:

Sudan GDP in 2007 - US$ 47.7 billion
World GDP in 2007 - US$ 54,347 billion
Sudan's share in world GDP = 0.088%

Sudan population in 2007 - 38.6 million
World population in 2007 - 6,612 million
Sudan's share in world population in 2007 = 0.584%

Cw for Sudan in 2007 = 0.088 / 0.584 = 0.151

Sudan's Cw in 2007 of 0.151 shows that the share of Sudan in world GDP was 6.6 times less than its share in world population.

Using the coefficient to measure economic growth places BiH in second place, after Lebanon, in the group of six countries studied for this project. The country in this group that saw the greatest relative improvement in its global ranking between 2000 and 2007 was Sudan with an increase of 112.7.

| Table 6. Changes in the Wealth Coefficient, 1990–2007 (in percentages) |
| --- | --- | --- | --- | --- | --- |
| Lebanon | .220 | .841 | .710 | + 282.73 | - 15.58 | + 222.73 |
| Bosnia and Herzegovina | .643 | .279 | .491 | - 56.61 | + 75.99 | - 23.64 |
| Colombia | .293 | .388 | .453 | + 32.42 | + 16.75 | + 54.61 |
| Sudan | .121 | .071 | .151 | - 41.32 | + 112.68 | + 24.79 |
| Sri Lanka | .113 | .163 | .199 | + 44.25 | + 22.09 | + 76.11 |
| Rwanda | .088 | .037 | .041 | - 57.95 | + 10.81 | - 53.41 |

Source: F. Causevic’s calculations, based on World Bank data.

Between 1990 and 2007, Lebanon experienced the fastest economic progress, while in 1990, BiH enjoyed GDP/pc that was 192 percent greater than Lebanon’s. At that time, Lebanon

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was severely affected by its civil war, while BiH was still within Yugoslavia, with a better than average economic performance. Moreover, the United Nations Development Programme (2007) places BiH among the high human development index countries, thanks to above-average accumulated investments in health, education, and human capital in the two decades from 1970 to 1990. Keefer (2008) also points out that BiH has far higher human capital stock than the post-conflict countries analyzed in his paper.

The World Economic Forum (2007) has identified the following six barriers to improved national competitiveness and faster economic development in BiH: inefficient administration, political instability, corruption, government instability, tax burden, and organized crime and theft. The first five of these obstacles are institutional or political in nature. The translation of the Dayton structure to economic governance gave each of the two entities greater, more effective economic policy authority than the state. While indirect taxation reform (2004–2006) enabled the Federation to take effective control of this area of fiscal policy, direct taxation policy and social welfare transfers have produced constant problems of ineffective coordination and often counter-productive measures, particularly during 2008 and 2009. Each entity’s government negotiates with foreign direct investors; therefore, the entities select their main strategic partners for infrastructure companies. They also retain authority over the privatization of state-owned companies.

This institutional division of responsibilities for the implementation of effective economic policy at the entity level, in combination with the ethnic division of the management of the major infrastructural companies or utilities, has contributed directly to the BiH economy losing elements of revenue which belong to it. A clear case of such losses is the generation and distribution of electricity and the management of natural resources from which electricity is generated. On the territory of Herzegovina (the south-west part of BiH), an artificial lake or reservoir was constructed during the period of the former Yugoslavia to serve as a resource for the generation of electricity for neighboring Croatia. During the entire post-war period, Croatia has not made a single payment under the pre-war contract which requires her to do so. Similarly, the hydroelectric reservoir on the stretch of the Drina River that belongs to BiH was used to generate electricity in neighboring Serbia. As with Croatia, Serbia has not paid its dues to BiH for using this reservoir in the post-war period. The explanation lies in the ethnic carve-up of the electricity sector in BiH.

What is logically a single natural and economic system for managing the generation and distribution of electricity in BiH was “broken up” after the war into three companies, based on a national or ethnic key: in the RS, Elektroprivreda RS or the Electricity Company of the Republika Srpska was created, managed exclusively by Serbs in BiH who have never demanded that the debt to BiH for the use of the hydroelectric resource on the Drina River be paid by neighboring Serbia. The example in the FBiH is an even clearer one of division along the lines of ethnicity: Elektroprivreda HZ HB was created in the areas where Croats make up the majority of the population under the exclusive control of Croats in BiH, while Elektroprivreda BiH is based in Sarajevo under the control of Bosniaks. While Busko blato (an artificial lake – hydroelectric reservoir) belongs to Elektroprivreda HZ HB, the company has never officially requested compensation or payment of debts owed by Hrvatska Elektroprivreda, the electricity company of neighbouring Croatia, for its use of the hydroelectric capacity.

Economic growth in BiH was relatively high in the 1998–2007 period, albeit hampered by mounting institutional and political barriers. What were the basic sources of that growth? Part

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of the answer must lie in human capital, much of which was inherited from the previous system. Yet, human capital was upgraded after the war by domestic and foreign investment, with support from the European Union and the United States.

The five most important exporting branches of industry in BiH over the 2003-2008 period were the following:

- The production of iron, steel, and iron and steel products. This sector’s share in overall exports rose from 7 percent to 14.1 percent. The total value of exports from this branch increased from KM 163 million to KM 998 million.
- The production of machinery, equipment, and electronic devices. This sector’s share in exports increased from 8.2 percent to 12.9 percent, while the value of exports rose from KM 191 million to KM 793 million.
- Electricity generation and the production of products of mineral origin is the third most important exporting sector, with a share up from 9.5 percent of exports to 11 percent and an increase in total value from KM 220 million to KM 660 million.
- The production of aluminum and related products is the fourth most important exporting sector of industry, following a decline in its share of the export market, from 13 percent to 10.8 percent. The value of exports from this branch, however, increased from KM 338 million to KM 655 million.
- The fifth most important branch in terms of exports is wood processing and manufacturing of wood products and furniture, with combined exports of KM 1,040 million.

Foreign direct investors have invested significant resources in the first two of these five branches, assisting the recovery of the Bosnian economy or at least allowing reasonable results to be achieved. Foreign direct investors did not play a dominant role in the other three branches. BiH's geographic position (the availability of coal stocks and water flows) makes it a very suitable area for the generation of electrical energy. In fact, BiH is one of the few countries with a surplus in electricity generation in Southeast Europe. Aluminum production is largely focused on the production of the Aluminij company in Mostar – another company established in the 1970s as a subsidiary of Energoinvest. The wood processing industry in BiH was highly developed within the framework of the former Yugoslavia, so that most of the companies present before the war as significant exporters of furniture or prefabricated buildings have re-established similar production lines now.

The relatively high level of human capital available in BiH in the pre-war Yugoslavia was the result of very intensive investment in education and healthcare, on the one hand, and in the intensive development of industrial capacity, particularly between 1970 and 1985, on the other. The economy of the former Yugoslavia, and so of BiH as a constituent element, had a market orientation. This market expertise in the areas of manufacturing, construction, and business services was preserved and represented a basic factor in the post-war rehabilitation of production and export capacity. The European Commission and the World Bank in their report on post-war BiH stated that:

The economy was fairly diversified, with a large industrial base and a capable entrepreneurial class that produced complex goods such as aircraft and machine tools. About half of output and employment was generated by large-scale heavy industry –
concentrated in energy, mining and metallurgy – as well as textiles, leather, and machinery. In the service sector, Bosnia and Herzegovina developed a strong capacity in civil engineering.\textsuperscript{67}

Available human capital in the manufacturing sector in BiH was stimulated between 1996 and 2009 by the approval of credit lines financed by USAID and EBRD to stimulate the development of small and medium-sized businesses. These credit lines facilitated the financing of productive capacity, as the interest rates on them were considerably lower than those charged by the domestic private banking sector. Combined with the inflow of foreign direct investment into the productive sector, these USAID and EBRD credit lines facilitated the activation of the human capital present in the sector.

CONCLUSIONS

The state of Bosnia and Herzegovina, as it was created by the Dayton Peace Agreement, demonstrates significant flaws of governance and lack of instruments for long-term stability and democratization that were sacrificed in order to fulfill the short-term goal of ending the war. The heavy reliance on external aid for economic and political stabilization yielded plentiful results in rebuilding war-destroyed assets, introducing development programs and building capacities for the governmental and NGO sectors, but at the same time it produced a dependency that will be difficult to overcome in the long term.

A major reason for lack of more expedient development can also be found in the flawed reform process. The country is administratively separated into two ethnically divided entities that exert vast authorities and undermine the state-level institutions. Without a full-blown constitutional reform that would simplify the gigantic state apparatus and disable ethnically motivated decision making, there is little hope for long-term stability. Supporting this elaborate institutional system is not only a burden to the economy but also a clear signal that ethnic segregation is condoned and ethnically motivated decisions are acceptable.

The lack of demand for a unified country on the side of citizens should not be considered an important factor for continued institutionalization of ethnic divisions and marginalization of moderate, non-ethnic movements. The NGO sector is well developed, but the motivation of most civil society organizations is linked to external funding and even profit. Real grassroots civic movements were never active in Yugoslavia and did not form after the war. BiH’s meager civil society is suffering from a lack of institutionalized citizen engagement in development and democratization. However, the power of civil society should not be underestimated. One potential way of correcting political elitism is by engaging the members of civil society more actively in the developmental process and pointing out the negative effects on every citizen of allowing an elite to hold all decision-making power.

As for the macroeconomic outlook, the situation is stabilizing. Monetary and fiscal policies are in place, foreign direct investments and exports are on the rise, and BiH’s vast natural and human capacities promise further progress. However, many issues remain problematic. The economy, like the other pillars of BiH society, is enmeshed in politics, which causes asymmetries in trade with neighboring countries. The privatization that occurred along ethnic lines due to the voucher system has reinforced administrative and political divisions in

\textsuperscript{67} The European Commission and the World Bank, Ibid. p.V (Introduction).
many places, including politically motivated leadership in the utility sector. These situations indicate that the economy is not immune to post-conflict ethnic divisions.

The six main barriers to improved national competitiveness and faster economic development in BiH remain inefficient administration, political instability, corruption, government instability, tax burden, and organized crime and theft. Except for organized crime and theft, these barriers fall into the political realm, demonstrating the need for political stabilization, which will strengthen economic development. BiH still has significant natural potential and human capital stock capable of achieving above-average rates of economic growth and development relatively quickly. However, for these goals to be accomplished, a better institutional structure of economic governance is required, without barriers between the entities or cantons, integrated to benefit all the constitutive peoples. As long as current ethnic divisions are supported by those in power, BiH’s natural potential and human capital will not be deployed effectively, and the value of these resources will depreciate.

The strongest hope for the country’s future seems to be accession into the European Union. Most analysts see accession as a tool not only for reforms of institutions and governance, but also for introducing into society a new European identity. Ethnic groups have been so isolated and emotionally tied to their separate identities that it seems utopian to believe that a Bosnian identity could ever exist in mainstream society. Therefore, perhaps only a broader identity, a new one based on being part of European culture, could become a unifying force among the ethnic groups’ younger generations. With the passage of time, citizens may be able to overcome their ethnic grievances and turn the society toward a European future. This road is long, and people are tired of the process, but the long-term goal of becoming more European and, thus, more secure within this new identity, could be the only incentive for stabilizing this war-shattered country.

**Principal Challenges and Possible Solutions**

*Power sharing*

In BiH, the overwhelming international leadership of the peace-building process has brought about sustainable peace but had led to the introduction of a “democracy” in name only without domestic institutions to support it. This can be considered the major flaw of the peace model in BiH. The Dayton Agreement effectively institutionalized ethnic divisions in the society and has prolonged ethnic politics. Instead of a democracy, BiH has the High Representative, whose power is supported by international institutions.

While there is no remedy for past developments except the benefit of hindsight for other post-conflict societies, major lessons have been learned and should be used to improve the current situation. Ethnically motivated thinking and voting must be overcome, replaced by a commitment to meeting the needs of the people: their well-being as individuals, as members of a healthy society, and as citizens of a country whose development they are proud to be a part of. The international presence should be gradually scaled down as the leaders of domestic institutions prove capable of sustainable, development-oriented actions. International support should be accepted to ensure European Union accession and to point the overall direction of society toward EU integration and the embracing of European values.

*Participatory Governance*
While millions of dollars have been invested in BiH development projects by the international community, no coordination among organizations was evident. This led to wasteful duplication of efforts and omissions of issues that were and are important to all BiH citizens. Simultaneously, there is no political consensus on constitutional and EU-related questions, which has impeded progress of the Public Administration Reform. Reasons for this can be found in the neglect of root causes of the war during the peace-building process and lack of comprehensive societal reconciliation. Citizens have not applied significant pressure for reform. This can be attributed to low expectations but also to a lack of belief in the efficacy of domestic institutions, due to the overwhelming IC role, and to the absence of reconciliation efforts, which has led to prolonged ethnic tensions. The civil society sector is weak, dependent on international funding and incapable of initiating and motivating serious societal movements.

BiH leaders must take the initiative to work together toward overcoming dependence on the international community’s leadership and funding by planning a comprehensive educational reform, targeted on capacity building and the empowerment of existing local experts. Stable economic development would also reduce the need for international assistance and contribute to strengthening state institutions and the country as a whole. EU accession can be used as another important tool for peace building, with its potential for helping citizens to view their various ethnic identities as important parts of their heritage and to understand that they can simultaneously be citizens of a reconciled BiH and Europe. Civil society needs to become an independent, driving force of change. For this to happen, governmental institutions must create an environment in which civil society is given a respectable role with significant power.

Macroeconomic Policy

BiH’s post-war economic situation is characterized by conflicting goals that have particularly affected economic growth and the labor market’s equilibrium. An extremely complex fiscal structure has prevented the federal government from collecting sufficient taxes. However, reforms in the areas of defense, indirect taxation, and border control have significantly increased the federal budget. A strengthened commercial banking sector has boosted investment and development. In contrast, the trade sector demonstrates an unwillingness to promote manufacturing, while elite economic groups conduct ethnically motivated trade with neighboring and other countries. FDI has been important for post-war development, but FDI-related legislation has not been favorable to local producers. The privatization process, lacking sufficient regulation, has also resulted in ethnically motivated sales, reinforcing old ethnic divisions.

Ongoing reforms have led and will lead to more efficient use of public funds for pension, healthcare, and unemployment benefits as well as education reform and generation of new jobs. As the political situation is inextricably linked with the economy, only stable political institutions will enable sustainable economic growth. It is crucial for BiH to build on its existing local human capital while developing new human capital—motivated people who are committed to working hard toward a shared vision will bring about long-term development. Given BiH’s relative lack of local ownership of manufacturing, unfavorable trade trends, and political obstacles to economic growth, its citizens are the country’s major strength.
**Powersharing**
Overwhelming international presence and leadership in the peace-building process have ensured sustainable peace but led to introduction of democracy without domestic institutions to support it. This can be considered the major flaw of the peace model in BiH. Current developments include prolonged ethnic politics, Dayton-imposed and –institutionalized ethnic divisions in the society and fulfillment of the power vacuum by international institutions, mainly the High Representative. While there is no remedy for past developments except the benefit of hindsight for other post-conflict societies, major lessons have been learned and should be used to improve the current situation. Ethnically-motivated thinking and voting needs to be overcome and focus placed on the needs of citizens, their individual wellbeing and development of the country as a whole. International presence needs to be gradually scaled down but only after domestic institutions have proved to be capable of sustainable and development-oriented actions. International presence should be taken advantage of to ensure European Union accession and overall direction of society towards the EU integration and embracing of European values.

**Participatory Governance**
While millions of dollars have been invested in development projects by the IC, no coordination efforts can be spoken of. This has led to duplication and omission of important issues. Simultaneously, there is no political consensus on constitutional and EU-related questions, which has impeded progress in the Public Administration Reform. Reasons for this can be found in the neglect of war root causes during the peace-building process and lack of comprehensive societal reconciliation. Citizens, on their side, have placed no significant pressure for reform. This can be attributed to low expectations but also lack of belief in domestic institutions (due to the overwhelming IC role) and absence of reconciliation which has led to prolonged ethnic tensions. The civil society sector is also weak, dependent on international funding and incapable of initiating serious societal movements.

Dependence on IC and its funding should be overcome through a comprehensive educational reform, targeted capacity building and empowerment of existing local experts. Stable economic development would also reduce the need for international assistance and thus contribute to strengthening state institutions and the country as a whole. EU accession is another important tool for peace-building due to its potential for overcoming ethnic identity and merging BiH identity with the European. The civil society on its part needs to become independent and a driving force of change. For this, support by governmental institutions is crucial to create an environment in which the civil society is given a respectable role.

**Macroeconomic Policy**
Post-war economic situation is characterized by conflicting goals that have particularly affected economic growth and labor market equilibrium. An extremely complex fiscal structure has disabled the state from collecting sufficient public revenue. However, defense, indirect taxation and border control reforms have significantly increased the state budget and the development of commercial banking has boosted investment and development. Patterns of trade demonstrate unwillingness to promote manufacturing and dominance of elite economic groups in conducting ethnically-motivated trade with neighboring and some other countries. FDI has been important for post-war development, but related legislation is not favorable to local producers. The privatization process has also resulted in ethnically-motivated sales.

Ongoing reforms have and will lead to more efficient use of public funds to use for pension, healthcare and unemployment benefits as well as education reform and generation of new jobs. It is crucial to build on existing and develop new human capital as this is the major chance for long-term development given the lack of manufacturing, unfavorable trade trends and political obstacles to economic growth. The political situation is inextricably linked to the economic one as only stable political institutions will enable sustainable economic growth, and vice versa.
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Francisco Gutiérrez Sanín68 and Juan Carlos Guataqui69


After suffering a major internal conflict between 1948 and the late 1950s and into the early 1960s (known as La Violencia), Colombia has never quite returned to “full normality” (Lleras Restrepo, Tomo 3, p. 357). For the purposes of this chapter, there are two characteristics of the 1958–2008 period that deserve to be highlighted. First, in Colombia, competitive politics and violence have long coexisted. Very few countries in the world share this characteristic. Second, Colombia’s leaders have tested a wide repertoire of strategies to deal with armed challenges, ranging from white-hot repression to negotiation, frequently putting both into the same “governance formula.” Thus, the last fifty years can be seen as simultaneously embodying a history of conflict and a history of peacemaking. Hardly a year has gone by without an ongoing negotiation between the government and a non-state challenger. The state’s Janus-faced efforts to deal with the problem have been, at least using the bluntest of criteria, unsuccessful: after fifty years of ups and downs, the government’s exclusive control of the legitimate use of violence has not been restored. Nevertheless, the intensity of the internal confrontation has gone down. In 2002, the paramilitary engaged in a peace process that terminated with the reinsertion of more than 30,000 combatants, and in recent years the main guerrilla groups have systematically received heavy blows. However, insurgencies have weathered much more critical periods and eventually made a comeback. As of 2011, the Colombian state still hosts an operating guerrilla network despite the reinsertion of the paramilitary. Whole families of anti-subversive/social cleansing/regional control structures associated with narco-trafficking, referred-to generically by the police as Bacrim, meaning Bandas Criminales, have managed to operate with success in several regions (Ortiz, 2011). Furthermore, the paramilitary political structures have remained and thrived (López, 2010). Very much in the spirit of former president (1964–1970) Carlos Lleras Restrepo’s aphorism, the country is still far, far away from “full normality.”

Now, this outcome is a bit puzzling. In terms of democracy, institution building, citizen participation, and delivery of services, the country has not systematically lagged behind any of its neighbors. So what can explain the Colombian state’s inability to attain peace? Two symmetrically opposed answers would solve the quandary without further ado. According to the first one, Colombia has been dominated by a bipartisan oligarchy, coalesced against any kind of reform, and intent on marginalizing the popular sectors from the public space (Guillén Martínez Fernando, 1996). According to the second one, the country has been governed by corrupt, dovish politicians who have neglected the defense of the state. If indeed the Colombian record in specific types of reforms is poor, and the investment in public security was strikingly low until 1998 (Gutiérrez, Viatela and Acevedo, 2007), neither of these simple answers can withstand empirical scrutiny. Over the last fifty years, several crucial reforms were launched by the state’s

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leadership, and some of them were actually inclusive and successful (for example, the 1991 Constitution). Several modalities of popular participation have been tolerated and sometimes fostered. On the other hand, practically no Colombian president has been above the exercise of extremely harsh, repressive measures. Colombia has not been ruled by particularly self regarding or dovish politicians; at least, not clearly worse in this regard than their Latin American peers. A more nuanced explanation is needed.

Colombia has had so many peace processes in the last decades that a systematic analysis of them would be a major undertaking—with the disadvantage that such processes have not been necessarily linked to either development/economic policies or institution building. Thereby, in this chapter we focus rather on the country’s two main experiences that combined peacemaking, power sharing, and economic policy making: the National Front (1958–1974) and the 1991 Constitution (C-1991). Both have incorporated actors that had been warring against each other into the public space, and both aimed to foster democracy and development. The National Front (NF) was a consociational accord (Hartlyn, 2008) between the country’s two main parties. Our basic claim with respect to the NF is that work toward its three main objectives—peace, development, and transition to democracy—could not be accomplished simultaneously. Somehow, working on any one of the objectives created obstacles for accomplishing the other two. The political elites tried to create a scenario to produce synergy among the three objectives but did not manage to do so. Thus, the experience was an instantiation of Hirschman’s motto, “Not all good things come together” (Hirschman Albert, 1981). The NF fell into a trap called (using the language of the period) inmovilismo or “stasis.” This stasis had fatal consequences for the country after an exogenous shock, the insertion of Colombia in the global markets for marihuana and coca, which activated violent dynamics and illegal economic activities in regions where the state had been traditionally weak. The 1991 Constitution was summoned when the traditional way of doing politics entered a deep crisis, and the main party, the Liberal Party, found that standard, normal politics had come to a dead end. The C-1991 was articulated with a peace negotiation that incorporated the Movimiento 19 de Abril (M-19) guerrilla organization, giving it political legitimacy. The M-19 rapidly became a protagonist and was able to capture nearly one-third of the seats in the Constitutional Assembly. Another goal of the C-1991 was to modernize the country, that is, to help it overcome old, corrupt politics and in so doing to include a wide array of new social sectors and actors, among them, reinserted guerrillas. However, peace efforts were stalled and the door to more aggressive policies was opened due to the following: 1) the country’s insertion in the global coca market; 2) a side effect of the state’s modernization program enabled illegal actors to capture chunks of the state, begetting a new type of armed competition; and 3) the fuzziness and gradual shrinking of the bargaining space. We will show that the failure to produce a sustainable, peaceful settlement was different in each case. However, some important commonalities can be found.

This chapter is organized to cover the following material. The first section is dedicated to the basic motivations and institutional architecture of the National Front. The second section focuses on economic policies and debates, especially on those oriented toward developmental and pro-poor objectives. The third explains the basic motivations behind the 1991 Constitution and the institutional architecture that it created. The fourth is dedicated to economic policies. The fifth discusses the 1991 peace program. In the conclusions, we discuss the Colombian state’s inability to produce a sustainable peace in the last fifty years, and we evaluate some facets of the international community’s participation in the Colombian conflict.
Colombia has a very long bipartisan tradition. Its two main political parties—the Liberal Party, Partido Liberal (PL), and the Conservative Party, Partido Conservador (PC)—dominated the political system until 2002, when they lost hold of almost all the key positions. Following standard academic and journalistic use, when we refer to them as a set we use expressions like “traditional parties” or “traditional politics” (these terms are not intended to be pejorative).

POWER SHARING AND PARTICIPATION DURING THE NATIONAL FRONT

By 1951, amid La Violencia (which would last for another decade and claim more than 200,000 lives), many members of the Conservative Party, then in power, acknowledged that the country had become unmanageable. Factional rows within the CP, plus the conservative government’s inability to stabilize the country either through repression or some type of accord with the Liberal Party (at that time harshly repressed and de facto banned from open participation in politics) ended in a military coup headed by General Gustavo Rojas Pinilla in 1953. This was Colombia’s second military regime in the twentieth century. Similar to the earlier regime, its main programs were to water down bipartisan polarization and rebuild the country. In this sense, it was a dictablanda: a closed regime, fearful of genuine political competition but intent on reducing the intensity of repression and of political confrontation. However, also as in the first military episode, the General Rojas used his position to try to perpetuate himself in power, which prompted the traditional parties to sign two accords of opposition to the dictatorship (at Sitges and Benidorm, in Spain), after which they were able to mobilize a wave of civil resistance that ended in Rojas going into exile. The whole episode was highly ritualized and relatively peaceful.

What were the main points of the Sitges and Benidorm Accords? First, the country had to enter a “democratic convalescence” by building an institutional setup that combined many of the standard aspects of democracy—such as freedom of press, freedom of speech, freedom of assembly, personal democratic freedoms, and freedom of conscience—with limited political competition. This meant that the party that lost a presidential election should not be brusquely evicted from power because the brutal struggle for bureaucratic posts, the diagnosis went, was the underlying cause of violence (See for example Guzmán G, Fals O & Umaña E., 1962). Thus, and second, a careful power-sharing structure was built, which guaranteed that each party had half of all posts, elected and non-elected, at all levels. Third, constitutional reforms and legislation had to be approved by super majorities (a two-thirds quota). This provided further guarantees that the party with a provisional majority would not be able to change the rules to perpetuate itself in power. Fourth, there would be compulsory rotation in power; each Conservative Party term would be succeeded by a Liberal Party term. Fifth, the country had to enter a path of accelerated development that entailed launching large-scale social reforms; extreme inequality and the failure of the state to deliver goods and services undermined democracy and increased the probability of violent confrontation. Sixth, non-traditional actors had to be excluded. If a non-traditional politician was ever elected, he had to declare his affiliation to one of the traditional parties before occupying his post. These six basic agreements

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70 To denote the Communist Party (Partido Communista de Colombia), we use the acronym CoP.
71 This was eventually relaxed, giving the Congress the right to decide which bills would be decided by the standard simple majority and which by the two-thirds quota. In practice, this did not change much, as it gave to any significant minority the power to try to block any bill it considered alarming.
were institutionalized rapidly and effectively after a 1957 plebiscite approved the creation of the National Front (NF) by a broad majority.

This new mode of governance gave the NF several simultaneous identities. First of all, it was a democratic transition, with almost all of the characteristics that the literature of the 1980s attributed to such processes (Ladrón de Guevara, 2002). Second, it was certainly a peace and power-sharing pact, in which the main contenders engaged in an extremely nasty confrontation and then decided to abjure the use of violence and invite their constituencies to compete in a reasonable fashion. Third, it was a vast developmental plan, with a stringent time horizon. Development was primarily conceived in terms of an anti-violence device. It meant prosperity and services as well as less inequality, so workers and peasants would have fewer incentives (or less incentive) to indulge in violence and/or be disloyal to the system. Furthermore, it was urgent, as many explosive materials had been accumulated throughout the years. The NF political elites did not shy away from declaring repeatedly that they did not have too much time, and that if the window of opportunity they had been given were not used properly, war and destruction would be the result.

It might be claimed, as some authors have done, that these nice intentions were eyewash and that the NF governments were captured by backward oligarchies that had every intention of blocking reform. This is an over-simplification. In reality, the NF ensured that the country engaged in a process of rapid change and modernization, and several crucial reforms were promoted from above. Growth was also achieved. All in all, as will be seen in the next section, the country’s economic path became viable enough that decent results were expected. However, at the end of the experience, the NF was discredited because it had failed to produce some of the crucial results it had correctly identified as pre-conditions for the achievement of a sustainable peace. Why? We show that the NF performed relatively well and that a significant sector of the leadership was endowed with the proverbial “political will” to foster change. Furthermore, the Alliance for Progress fostered decent opportunities for prophylactic, anti-communist, but not necessarily cosmetic, reform in an ambience of benevolent indifference. But the peaceful designs of the NF blocked its reformist intentions because it empowered minorities to block key legislation. This generated a series of vicious circles, which, in turn, ended in a highly fragmented main political party of the country. In the hands of regional and local bosses, politics was heavily slanted in favor of those social sectors that had many reasons to oppose reform and were opposing it actively. In the meantime, a series of guerrilla groups formed. While this was a phenomenon common to all Latin America, in Colombia, given the previous wave of confrontation, the guerrillas had mastered skills that other countries’ irregulars lacked. When the National Front period ended, despite important achievements in social policy and economic growth, NF governments had not achieved macro reforms, and the country was starting to heat up again. Colombia’s links to global markets and its place in the international context would soon change substantially, and the country’s window of opportunity would close.

THE NATIONAL FRONT: A TOLERABLY GOOD PERFORMER

At the outset of the National Front, Colombia was an agricultural economy with an underdeveloped internal market and dominant primary sectors (agriculture and mining accounted for almost 40 percent of GDP and 55.5 percent of employment). Manufacturing had a share of 17.4 percent of GDP. In terms of economic policies, the country had started to apply the
recommendations\textsuperscript{72} contained in the 1950 World Bank commission’s recommendations (López, 1998), and during the NF it operated under the aegis of the Alliance for Progress (Fajardo, 2003). Just prior to the NF, the Colombian economy had a growth rate of 6 percent but was starting to face both fiscal and monetary pressures, the first ones arising from publicly financed infrastructure projects and their subsequent impact on the fiscal deficit.

One of the first measures of the Alberto Lleras Camargo presidency (1958–1962) was an administrative reform that aimed to deal with fiscal instability, which was attributed to the international crisis of coffee prices and the lack of coordination over the economic policy (López, 1998, 334). This reform, Law 19 of 1958, created the National Planning Department (DNP) and the National Council for Planning and Economic Policy (CONPES).

Inflation was a major economic and political issue during the NF, though it never reached the very high levels of the majority of Latin American countries; by 1974 inflation was 26.04 percent. In contrast, the period witnessed a spectacular increase in the state’s provision of services to the population. Additionally, high levels of income inequality were very moderately reduced with better results than in the following periods. As seen in Figure 1, until 1975, the country witnessed a decreasing Gini Coefficient (indicating a decrease in income inequality), a trend that strengthened and then stagnated in the 1980s. The evolution of the Gini coefficient in Colombia can be divided in three stages. First, a gradual but systematic decrease (e.g., a trend towards less inequality) during the National Front. Then, a period of ups and downs that ended, probably due to the anti-poverty policies implemented during the Virgilio Barco administration (1986-1990) in a historical low. Finally, an increase and a further stabilization at very high levels from 1990 on. How can the fall in the inequality levels during the National Front be explained? First, Colombia had a decent GDP growth rate (an average of 5.37 percent for the period). As seen in Table 1, this was quite good by Latin American standards.\textsuperscript{73} Second, an import-substitution and export-friendly orientation (promoted especially by the Lleras Restrepo administration, 1966–1970) was relatively successful. Third, fiscal prudence followed by a slackening of fiscal oversight allowed steady growth of the Colombian bureaucracy (Uricoechea, 1968).

In sum, despite serious political issues, Colombia was growing economically and providing more and better services to its population against a landscape of very high income inequality. Between 1953 and 1964, housing conditions and the access to public utilities improved significantly: earth-floored houses as a share of the housing profile fell from 53 percent to 38 percent, houses built with poor materials fell from 90 percent to 51 percent, houses with aqueduct access increased their share from 29 percent to 39 percent, and those with sewerage services went up from 32 percent to 41 percent. For the 1964 to 1973 period, aqueduct access grew up to 63 percent, and sewerage services access grew to 68 percent. Infant mortality rates also fell, but this responded to more long-term trends, starting in the 1930s. Infant mortality rates fell by more than 50 percent over a 20-year period: from 124 deaths per thousand births in the 19511964 period, to 56.7 deaths per thousand from 1975 through 1980. Rico-Velasco (1992) attributes this outstanding improvement to the fact that preventive health programs quickly reduced incidences of most of the diseases related to high infant mortality rates. During the NF, Colombia also evolved from being a rural to an urban country. Between 1951 and 1963, the annual average rural-urban migration rate was 2.3 percent. This migratory flow increased during

\textsuperscript{72} The Basis of a Development Program for Colombia, a report of the June 1949 World Bank mission to Colombia, was made public on August 13, 1950 (http://web.worldbank.org, Archives).

\textsuperscript{73} Note that the time periods in Table 1 do not correspond exactly with the time periods established in this study.
the years between 1964 and 1973, rising to 3.3 percent (Banguero et al., 1983). Part of this flow was caused by violence.

THE DEFEAT OF REFORMISM

From the 1950s through the 1970s, Colombia was a society experiencing growth, urbanization, and modernization though several problems remained. The developmental model of the country, gradualist and carefully managed to escape the boom and boost cycles of many other Latin American countries, did not deliver spectacular growth, but it produced consistent outcomes. While Colombia was at least as healthy economically as its neighbors, it was more violent. Carlos Lleras’s aphorism, stating that the country never quite returned to full normalcy, is correct. However, as a peace project the NF was anything but a failure, despite the rather difficult conditions it faced. At the outset of the NF, a host of potential spoilers—from General Rojas and supporters of the previous military regime to radical conservatives who felt that delivering power to the Liberals was outright treason—expressed doubts about the project, but their criticisms were gradually neutralized. Despite orders from the two parties’ leaders to cooperate, many liberal guerrillas and right-wing conservative hit men kept active in the regions, and some of them networked with criminals and politicians to produce regional structures with the military capacity to challenge the state. As a product of La Violencia, a sector of liberal peasants had become radicalized, and some started to adopt an ideology against the conservative regime that went beyond self-defense. These poor farmers originated the Bloque Sur and eventually the Fuerzas Armadas Revolucionarias de Colombia (FARC), a guerrilla movement originally associated with the Communist Party (CoP), whose members were already weathered veterans of the La Violencia episodes. These guerrillas, who knew how to fight, had managed to challenge the government, and had survived, were catalyzed by the Cuban revolution, which enthused thousands of youngsters throughout Latin America. While in the rest of the continent armed resistance was generally rather inept and rapidly crushed, the Colombian government was unable to eradicate the FARC, largely because of the guerrillas’ skills and traditions and their knowledge of the mountains. Even then, the NF’s performance with respect to the insurgency cannot be derided. None of the several insurgent groups that formed in the mid-1960s was able to grow. For example, in 1978 the FARC was still a very small force with only 780 people in arms, (Ferro and Uríbe, 2002) and the others were even smaller.

We do not know if armed struggle was attractive for certain broad sectors of the population, as opinion polls only started to be performed systematically at the end of the NF. We do know that some popular leaders were attracted by the example set by the guerrillas and that an important sector of the youth, especially in the universities, held radical sympathies. Nonetheless, the guerrillas were rather isolated politically. Broderick speaks about the “imaginary war” waged by the Ejército de Liberación Nacional ELN (Broderick, 2000). Perhaps the struggle of the FARC was a bit less imaginary. By 1962, the peasant nuclei of the FARC gained national recognition when they were denounced by a Conservative faction in Parliament as leading “independent republics” in the South of the country. The “republics” were bombed, but the group survived, achieving thus an important military (and probably political) success.

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74 In this section we draw heavily on Gutiérrez, 2007.
75 In the late 1970s and early 1980s, other serious armed challenges occurred in Central America and Perú.
76 This was probably much more a result of the internal factional dynamics of the CP than of the true importance of the so called “independent republics.”
However, the FARC rapidly lost momentum and by 1970 was quite isolated. The CoP did not perform well in elections even when results were controlled for exclusion. The frequent claim that somehow the NF “legitimized” insurgency needs to be expressed using more nuanced language. At the end of the NF, the guerrillas were far from being the stars of a success story. The ELN was crushed during the 1973 Anorí operation, and the FARC also received hard blows (for example, in 1967). Other insurgent groups did not fare better with one important exception, which will be treated separately.

Criminality became an NF highlight, as happens with rapidly urbanizing societies. The NF leaders faced a host of new problems posed by demographics and social change, and they were not always able to provide deft solutions. Even then, accepting the issues that violence involves, both politically caused and aggregated homicides appear to have decreased during the NF. This picture is tentative, but other data suggest that these types of crimes declined. Why, then, did the NF experience eventually lose most of its popular support? In effect, at the end of the Front, the prevalent feelings among citizens about the government were rejection and bitterness, which led to an urgent call for change. That this is the case seems beyond reasonable doubt (Gutiérrez, 2007).

There are three main reasons for the NF’s deterioration. The first reason was the high cost of the mode of power sharing that was adopted. Contrary to other Latin American experiences (for example Venezuela), the NF excluded the left from participation. Furthermore, the scheme itself was comprehensive, as it included the judiciary. This annulled a substantial part of the normal system of checks and balances. Whenever there was a convergence of interests of the politicians of both parties, they could easily coordinate all the branches of public power to short circuit any type of restriction, including those regulated by laws. In towns and municipalities, for example, traditional leaders were able to create stable fiefdoms by controlling the municipal council, the mayor, and the judiciary. At the national level, politicians had the power to set their own salaries and travel agendas, and they were not above using this prerogative as a bargaining chip, especially when the executive needed the urgent approval of critical bills. It would be wrong, though, to go too far in this assertion. Many examples of congressional, judiciary, and constitutional controls during the NF can be found. Even then, the latitude given to politicians of the two main parties made power sharing a symbol of aloofness and corruption.

The second reason for the NF’s demise is that its reformist agenda failed or went too slowly. According to the NF politicians themselves, reforms had to be undertaken quickly in order to have their intended effects of reducing violence. The reformist agenda failed because the NF excluded the left and the partisans of General Rojas. These groups eventually formed a force called Alianza Nacional Popular (ANAPO), which must have weakened the transformative potential of the NF’s political system. The exclusion of these groups was, in some sense, rather formal. For example, throughout the NF period, ANAPO held parliamentary representation; its members in the legislative branch simply had to declare Liberal or Conservative affiliations before occupying their seats, but they could operate without further restrictions. The CoP was much smaller, but even then it was able to participate in Parliament in alliance with a Liberal splinter group, the Movimiento Revolucionario Liberal (MRL). Furthermore, neither the ANAPO nor the CoP was in a better position than the traditional parties to push forward the agenda of macro-reforms (mainly but not only the agrarian one). The institutional exclusion only explains a part of the impotence of the reformist drive.

At least two additional factors that undermined the reforms must be taken into account: supermajorities and factionalism. Supermajorities played a huge role. Despite the fact that the
supermajority rule (SR) was relaxed somewhat in the 1968 Constitutional Reform, it remained a fundamental piece of the architecture of the pact. The SR entailed giving big chunks of power to small minorities, fostering the proliferation of veto actors. This is illustrated in Tables 2 A and 2 B, which analyze an electoral scenario in the Lower House in 1962. The situation was the following. The majority of the members of the House belonged to the NF coalition. There were one ANAPO member, one NF defector, and the MRL, which had a “hard” and a “soft” wing (for details, see Table 4 A). Given this distribution, there were several possibilities: the MRL voted together or separated into its wings. A study by Gutiérrez (2007) utilized the Banzhaf index, a standard voting power index, to illustrate that when the standard quota was used, the NF bloc had all the power; however, with the supermajority rule, the NF and MRL blocs had equal voting power. Though these scenarios are oversimplified—poor intra-NF discipline also affected outcomes—the real-life contrast is even neater. The simple implication of the NF’s power-sharing formula was that to pass any bill, the government had to negotiate carefully with every liberal and conservative faction to gain their support. Otherwise, the proposal ran a high risk of being defeated. As a matter of fact, transcriptions of the debates on agrarian reform show how obvious this specter was for all the actors involved. That this was common knowledge only increased the SR’s veto power. As dissident and anti-NF votes gradually increased, the government’s situation became more tenuous.

This had an immediate connection with the second factor, the evolution of the political system. The Colombian parties had always allowed factions much latitude. When the two main parties entered into the NF, they both were severely divided, especially the CP. Then, the NF implemented a state-community pact, institutionalized through an association of neighbors, the Juntas de Acción Comunal. According to these community action groups, the basic elements for the developmental process were contributed in the following ways: the state provided the goods and the infrastructure, and the community contributed the manual labor. The intermediaries between the state and community groups were traditional politicians. Politicians identified communities’ needs and loyalties. Very rapidly, this scheme empowered regional politicians at the cost of the political center. This can be seen through the brutal growth of factionalism in both parties, especially within the LP. At the end of the National Front period, in the majority of electoral districts, the LP was presenting more lists than seats (Gutiérrez, 2007), ostensibly a suboptimal practice from the point of view of the party (because at least some votes would be squandered), but not necessarily bad from the points of view of individual politicians. Thus, the outcome could be explained as blatantly irrational or as a product of the growing autonomy of politicians with respect to their parties. Regional bosses were increasingly empowered, becoming as important in their capacity as vote gatherers as in their identification with the Liberal or Conservative party. These bosses tended to be anti-reformist, intimately linked as they were to the traditional regional agrarian elites; in some departments, they were actually the representatives of those elites (Escobar, 1998). Given their position as brokers, they had strong incentives to assess individual rents (bribes) for their political activity. The regional bosses’ factional activity was rewarded with strong voting power, which encouraged them to blackmail the interests they represented to increase their incomes. This behavior is similar to practices of politicians in many other countries when they accept contributions for their future election campaigns from lobbyists in exchange for voting in favor of the lobbyists’ interests.
Now it is easy to understand why macro reforms, like the agrarian one, failed.77 Using Sartori’s slang, traditional parties had “fractions,” that is, national, ideological trends, and “factions,” regional and local, pork-oriented, groupings. For example, an important CP fraction opposed social reform. Of the factions, all of them had good reasons—because of their links to regional elites and their interests as brokers—to block bills and ask for perks to allow them to pass. Activist presidents had to overcome both obstacles, which were formidable, given the pro-peace institutional designs. The 1968 constitutional reform process, for example, was extremely traumatic. In order to pass the reform through Parliament, President Carlos Lleras Restrepo (1966–1970) had to offer regional politicians more permanent, substantial access to pork, which increased their power even more.

Summing up, it is not the case that the NF was devoid of any reformist programs. On the contrary, it was obsessed with them. In some cases, like national and subnational economic planning, the reform was implemented, although with mixed results, as in many regions clientelistic cliques captured planning. With respect to the agrarian reform, the Alliance for Progress and its call for prophylactic social change found the Colombian elites well prepared. They also believed in the Alliance’s anti-subversive and anti-violence potential. In 1961, President Alberto Lleras Camargo (1958–1962), with modest success, promoted a first try. In 1966, the agenda was revived, as the newly elected president, Carlos Lleras, was probably its main ideologue. To push it forward, Lleras promoted the Asociación Nacional de Usuarios Campesinos (ANUC), that eventually became the biggest peasant movement in Latin America (Zamosc, 1978). Lleras calculated that pressure from above plus pressure from below, along with benevolent indifference from the United States, were nearly ideal conditions for reformist success. However, the staunch opposition of the rural land-owning elites and foot-dragging by politicians, including those of President Lleras’ own Liberal Party, substantially watered down the proposal and eventually blocked it. The link between big landowners and regional/local politicians was strongest in what was probably the main LP stronghold: the Atlantic Coast. Atlantic Coast landowners had the power to punish the LP electorally if reforms went too far. Under these conditions, the ANUC leadership was seized—against Lleras’ predictions—by radical cadres of different ideological hues (Maoist, Trotskyist, and others). Instead of convergent pressures, Lleras found himself in a scenario of loss of control. The next and last NF government eventually buried the reform, which was formalized by the Chicoral Pact (1972) between the government and landowners.

This exemplified typical NF inmovilismo. In the meantime, broad sectors of the public were getting increasingly impatient, as both the activity in the streets and electoral results were showing. In the 1970s, the majority of votes went to unofficial NF candidates. The official NF candidate managed to beat ANAPO’s General Rojas by a razor-thin margin. Lleras was accused of stealing the elections. While this has not been fully proven, the free transmission of news about electoral results was abruptly interrupted just when Rojas had taken the lead. This irregularity radicalized a sector of the ANAPO that had roots in the masses, and a new guerrilla group was born, the Movimiento 19 de Abril (M-19). While the M-19, which reinserted in 1990, was never a particularly skillful military player, it was much more apt politically than the other guerrillas. It was able to bring the war to the center of the political stage. But this goes beyond the period covered by our study.

77 Many of Colombia’s neighbors (Perú, Ecuador, Bolivia) were able to make macro reforms under nondemocratic regimes.
The epilogue of the NF is as follows. At the end of the NF, the traditional parties were undergoing a deep change, as they were increasingly being captured by regional brokers. One result of the institutional closure of the NF was a new type of guerrilla. The NF power-sharing scheme had no clear, viable response to its defeat in the elections. By the mid 1970s, the country became linked to the global markets of marihuana and eventually coca. These crops grew rapidly in regions such as the South, where the state was extremely weak with no infrastructure and very low population density. Regionalized politics, high levels of corruption, new and powerful anti-system motives, and new rents that entailed the incorporation of big stateless areas of the country into illegal global markets formed an explosive combination.

We have shown how attempts to achieve the power-sharing, peace, reformist, and development designs obstructed each other. The reasons for the roadblocks are the following:

1. Vicious circles. For example, fragmentation fosters empowerment of small groups, which, in turn, fosters fragmentation;
2. Timing issues. Windows of opportunity open and close. The political processes that allow agents to profit from the opening may last longer than the period when the window is open;
3. The existence of disaffected people with dangerous skills (previous waves of conflict had created a sector of capable specialists in violence);
4. The attainment of one desirable objective blocks the attainment of another one. Guarantees to minorities empowered factions and factions, which stalled the reformist and developmental agendas.


In the late 1970s and early 1980s, there were two important developments. First, war and violence severely increased in intensity. Second, the interaction between organized crime and a highly fragmented polity went out of control. In particular, the dominant party of the political system, the Liberal Party, was captured by a set of factions that based their loyalties on pork-barrel cronyism (the benevolent version). The other, more realistic version acknowledges that the LP was taken over by criminalized factions. Luis Carlos Galán, a dissident LP leader, launched an offensive against the oficialismo (that is, the central leadership of the LP) with mixed results, but maintained a good performance in the capital, Bogotá. When it appeared that Galán was going to win the presidential elections, he was assassinated by the mafia to satisfy the politicians allied with it.

The decade of the 1980s was a period of deep crisis and permanent turbulence. Thus, by the late 1980s, Colombia was facing the following large-scale problems simultaneously:

1. A medium-intensity political war. The guerrilla groups had grown rapidly. The FARC was achieving its peak of 20,000 members. The ELN had perhaps half as many members. Other groups were smaller and less skilled militarily, and they eventually joined the guerrilla alliance, Coordinadora Guerrillera Simón Bolívar. On the other end of the spectrum, paramilitary groups, composed of narco-traffickers, cattle ranchers, and agents of the state proliferated (Gutiérrez and Barón, 2005).
2. A terrorist war against the state was declared by the Medellín cartel to combat the extradition treaty signed in 1978 by Colombia and the United States.
3. A narco penetration of the state, of which the Cali cartel was the main but not the only player. Narcos and other criminals systematically penetrated the police, the army, and the political system.

4. Traditional politics remained rural in nature in a country increasingly becoming rapidly urbanized by several socioeconomic forces, including violence.

These problems had been dealt with by tinkering with the political system and by a gradual but nonetheless palpable modernization of the state. At the heart of it was a decentralization program that, though rejected by the mainstream LP by the beginning of the 1980s, came to be accepted and was institutionalized by the middle of the decade. The decentralization was composed of fiscal, administrative, and political elements. Political decentralization included the popular election of mayors, a measure that the neighboring Andean countries had taken a long time before.

Violence and corruption threatened to jeopardize the international conditions for stability of the Colombian state. For example, in 1989 the majority of the LP voted in favor of a reform that would submit the grounds for extradition to a popular vote, and President Virgilio Barco used a legal artifice to push forward a Constitutional Assembly (CA). The CA was summoned during the next administration (Gaviria, 1990–1994). In the meantime, four presidential candidates, including the probable winner, were assassinated. The 1990 presidential and CA elections revealed how deeply the Colombian political system was in crisis. In the CA elections, a new political party, the Alianza Democrática M-19 (AD/M-19), made a spectacular showing, coming in second and capturing nearly one-third of the seats (the AD/M-19 comprised the demobilized M-19 and members of several other former guerrilla organizations). But in those elections, called to re-legitimize politics and the state, the electoral turnover was lower than the historical average.

The Constitutional Assembly of 1991 accomplished the following:

1. It expressed several plans for improving relations between society and the state: those linked to a neoliberal and technocratic program of modernization; those associated with social movements; and those that promoted regional, social, and cultural diversity (there were intersections among all of these).

2. The CA was intended to formulate a peace pact composed of a set of proposals that expressed the populace’s aspirations. Since it came after the negotiated demobilization and reincorporation of the M19 and the EPL into society, and the M-19 was utterly successful in the electoral terrain, it could symbolically express reconciliation. Those who organized the CA also aspired to lure the FARC into a negotiated peace, an effort that ended traumatically. In a silent and restrained way, it also addressed the interests of the narcotics, not in a criminalized way, as in 1989, but as part of a program of national reconstruction. Extradition of Colombian nationals was banned. Eventually, extradition was reintroduced by President Samper, so that criminals whose activities affected citizens in other countries could be tried for their crimes outside Colombia.

3. It created key agencies and mechanisms to deal with criminality.
4. It was also a social, egalitarian undertaking. Indigenous peoples and afro-Colombians were empowered and received important assets, especially lands, through the creation of resguardos (protected resettlement areas).

5. Decentralization was strongly emphasized.

The architects of the CA conceived of it as an effort to open the Colombian economy, its political system, and its society. The three openings were considered isomorphic. The economic apertura (opening) program is described in detail in the next section of this chapter. It corresponded basically to a set of neoliberal reforms, with nuances and context-driven specificities, that were implemented throughout Latin America in the 1990s. The main effort with respect to the political system was to lower the formal barriers to entry of new political actors. As these barriers were by then fairly low and the Colombian Hare electoral quota system was one of the most proportional in the world, the main step was to institutionalize “participatory democracy.” A set of devices associated with decentralization allowed citizens to engage in various forms of participation in addition to voting. The electoral menu was also broadened significantly. Mayors, thanks to a 1986 reform, were elected instead of appointed from 1988 and were given new attributions at the constitutional level. Popular election of governors was introduced. The Senate’s members, formerly voted on within departmental districts, would now be elected by a single, national district, which made the elections even more proportional. With respect to society, the defense of individual rights was strengthened significantly. For example, the acción de tutela (writ for the protection of constitutional rights) allowed citizens to present a complaint to the judiciary without the intermediation of a lawyer, if their fundamental rights were jeopardized. New groups that represented modern, diverse Colombia, from religious denominations other than Catholic to sexual minorities, promoted and utilized these changes.

One may wonder whether this set of aspirations and proposals was internally consistent. The Constitution of 1991 (C1991) was arrived at through bargaining. The document’s different versions of modernization were negotiated by mutual concessions; each representative in the CA tried to guarantee the constitutionalization of his or her own program. This is one of the reasons why it is so long. The Constitution was intended to be both power-sharing and peace-oriented, although in a very different sense from the rules promulgated by the NF. C1991 power sharing was asymmetric despite the spectacular success of the AD/M-19 in the CA elections. The two main parties were deeply rooted, had loyal cadres, deep knowledge of the state, and traditionally had held all political power. While the NF had incorporated into the pact the main contenders of a civil war, which had involved society as a whole, the C1991 tried to manage a confrontation in which the majority of the citizenry felt like spectators. Peace was made with the weakest of the military groups. This wasn’t necessarily bad. The architects of the process believed that an opening and legitimizing of politics, plus positive public examples (for example, despite the assassination of its presidential candidate in 1990, the M-19 did not suffer a butchery as the Unión Patriótica had) would eventually produce a strong pro-peace environment.

However, after the C1991 was signed, peace did not follow as expected. The war increased in intensity, revealed by figures and qualitative descriptions. Neoliberal reforms were undermined by a high degree of social mobilization but probably significantly less than by Latin American standards. The economy grew at a distinctly lower level than the NF average (see

79 Though the NF’s constraints had long disappeared, members of the opposition were assassinated regularly.
Table 1). In 1998–99, the economy went into a deep slump, which had strong political implications.

THE ECONOMIC DIMENSION

The Gaviria administration (1990–1994) assembled a whole set of reforms in order to provide institutional support to the new economic model. According to Lozano (2001), the structural reforms were the following:

1. Trade Reform: It included organizational activities and the creation of a Foreign Trade Ministry; an information and regulation agency, Incomex; a promotion institution, ProExport; and a financial front, Bancoldex (el Banco de Comercio Exterior de Colombia) as well as policy measures, including a reduction of the nominal tariff from 49.4 percent to 11.7 percent on imports.

2. Exchange Administration Reform: The crawling peg exchange rate regime was maintained until 1994, when exchange rate bands replaced it. By the end of the 1990s (September 1999), a free-floating exchange rate system was implanted.

3. Financial Reform: The relationship between the monetary authority and the government was revised. The Central Bank was given full independence and tasked with the constitutional mandate of fighting back inflation. Additionally, the financial sector was opened to foreign direct investment and private property ownership.

4. Employment Reform: The social security framework was modified to create an individual pension regime, a new public health system, and a full-fledged flexibilization of labor.

By the first half of the 1990s, both the average inflation rate and its variance had fallen substantially (Meisel, 1996, 12). In contrast, key state processes, such as taxation, were never fully stabilized. At least eight national tax reforms took place in this ten-year period. As a whole, the Colombian fiscal performance through the 1990s was rather disappointing. From 1990 to 1995, the average fiscal deficit, measured as a share of GDP, was 0.04. Between 1995 and 2000, it increased dramatically and steadily, reaching an average of 3.34 percent. Indeed, by then the Colombian state was facing severe fiscal pressures, coming from the following:

1. Transfers of funds generated by the decentralization process;
2. Increasing contributions from the government to the new social security system;
3. Suboptimal management of the government’s revenue.

The adoption of the Constitution itself, of course, was related to a significant fiscal effort. As a share of GDP, central government expenditure grew from 11 percent in 1990 to 18 percent in 1998, and half of this increase can be directly explained by the new expenditure commitments. For example, the investment in justice grew sharply in the aftermath of the new Constitution (BID, 2003; see Figure 2). The government’s revenues despite—or perhaps precisely because of—recurrent tax reforms did not grow at the pace required to face the increased rate of expending.

In the first half of the 1990s, the economy seemed to be responding as expected. The average GDP rate of growth was 4.51 percent. From 1996 onward, macroeconomic conditions
deteriorated, and the GDP’s rate of growth fell to 0.96 percent. In the first half of the 1990s, private investment increased due to real estate sales and construction, but this did not become a trend. A systemic banking crisis, combined with a contraction of the most dynamic economic activities, combined to increase the country’s vulnerability to external imbalances. The Russian and Brazilian crises of 1998–1999 reduced capital flows, deeply affecting both the trade and fiscal deficits. By 1999, Colombia was facing its most dramatic economic recession in more than 60 years.

There was a dramatic regression in social development. Although most of the social indicators related to the long-term development process (such as in health and education) were not deeply affected, those that were strongly related to short-term economic outcomes suffered strong negative shocks. The unemployment rate, which by March 1990 was 10.1 percent and by September 1994 was reduced to 7.58 percent (the lowest unemployment level ever recorded in the public records), eventually increased to more than 20 percent at the end of the decade. This radical deterioration of labor market conditions was also reflected in household incomes and income distribution. Between 1990 and 1999, real labor income by economic sector of activity did not grow in eight out of ten economic sectors, and income inequality became even worse as the Gini Coefficient deteriorated from 46 percent to 53.3 percent (see Figure 1).

As discussed in the next section, the difficulties associated with the coordination of democratization and liberalization, the presence of a war linked with a global illegal market, and the drastic weakening of the coalition that gave origin to the constitutional pact once again destabilized the efforts to produce a sustainable peace.

PEACEMAKING AND POWER SHARING AFTER THE C1991

Note the similarities and differences between the NF and the C1991 experiences. Both were designed by the political elites when they were confronted with a large-scale crisis. Both were thought of as processes of modernization. Both came at times of critical international conjunctures—the NF with the Cuban revolution and the Alliance for Progress and the C1991 with the end of real socialism in Eastern Europe—yet responded to major national problems and traditions. The NF was grounded in a CEPAL-based model, which identified the creation of an internal market and import substitution industrialization as the ways toward development and stability, while for the C1991, the key was the open market-open society-open polity isomorphism. Furthermore, the NF in effect ended the bipartisan war and contained the new, revolutionary war. The C1991 was much more effective as a democratizing force, and in the last two decades, it has held its own as a source of legitimacy. While a broad spectrum of the population, including members of the political elites, were disappointed with the NF experience during its first years, the C1991 is still eulogized, even by its adversaries.

How should this contrast be understood? We start with the power-sharing story, and then turn to the story of peace. The tripartite presidency of the Constitutional Assembly (CA) had the following composition: a member of the M-19 (Antonio Navarro), a member of the Liberal Party (Horacio Serpa Uribe), and a member of the Movimiento de Salvación Nacional (a CoP radical splinter group. The three expected to represent the coalition that was to govern modern Colombia and express the huge, multiclass rage against criminalized politics. In fact, the 1990 CA elections marked the first time (if we are agnostic enough with respect to the 1970 NF episode) that

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80 CEPAL is la Comisión Económica para América Latina y el Caribe (the UN Economic Commission for Latin America and the Caribbean—ECLAC).
traditional parties were defeated in an election. The CA crafted several institutional mechanisms to permit the alliance of modernizers against the mainstream LP leaders. The first was the introduction of the runoff for presidential elections. The second was the introduction of the position of vice president, and as in other countries, the governing functions of this office were rather hazy. In the Colombian context, the vice presidency was basically an electoral device. It was expected that a presidential ticket with two figures would allow second-round alliances against strong LP candidates. As complementary aspects of this plan, the electoral system was made even more proportional with a single electoral district for the Senate, and the repertoire of participatory tools for citizens was multiplied. Beyond purely electoral issues, the creation of a powerful independent agency in charge of the prosecution of major criminal offences, the Fiscalía General de la Nación (Office of the Attorney General of Colombia), would buttress the capacity of the state to combat organized crime effectively and weaken its links with politics.

All of the CA’s modernizing measures were consequential but not necessarily in the sense and direction expected by their architects. The measures were defeated electorally in a spectacular manner between 1991 and 1994. Though the M-19’s success in the 1990 election triggered a wave of hope, its leadership did not adequately understand the workings of the state, and in general its parliamentary caucus members performed poorly. The other two forces, the LP modernizers and the CP dissidents, lost their internal struggles and were incorporated into other fractions. By 1994, the traditional parties and practices had made a comeback with full force. The coalition that forged the Constitution had evaporated. After two very turbulent governments of the LP and CP, respectively, power fell into the lap of Álvaro Uribe, an LP dissident who built a very broad majority with a program that in many areas was not necessarily compatible with the letter of C1991 and was definitely at odds with its ethos.

With respect to peacemaking, the C1991 was the child of a successful process that entertained hopes of achieving a definitive settlement with the major guerrilla groups, the FARC and the ELN. The negotiations broke down, and war raged with renewed impetus. President Gaviria was not able to achieve peace during his administration. As discussed above, the NF elites had attributed the violence of political partisanship to a combination of the self-serving brutality of political operators and economic inequality. According to the C1991 architects, violence was a product of democratic closures and a legitimacy deficit. Thus, the stained election of Ernesto Samper (1994–1998) was seen by many as a major step backward. Samper simply did not have the time or energy to engage in serious, sustained peace efforts. He was succeeded by Andrés Pastrana (1998–2002), the forerunner of 1994, whose main promise was to bring peace and moral accountability to the country.

Pastrana had had previous contacts with FARC leaders and was ready to take spectacular steps. He conceded to the insurgents a 42,000 km² demilitarized zone around their headquarters in southern Colombia and initiated formal talks. The guerrillas, though, insisted in negotiating without suspending hostilities, resulting in terribly disruptive events. Additionally, it was clear that the FARC leadership did not have a clear idea of what to demand; state officials in charge of the process did not have a much better idea of what they could actually offer. The conversations stagnated amid an escalation of violence and institutional disarray. The “third actor,” the paramilitaries, chipped in, sabotaging many of the peace initiatives, and eventually launched a

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81 The C1991 also pioneered a small peace agreement with the paramilitary groups.
82 It was proven that Samper’s campaign received massive funding from the Cali Cartel narcos. President Samper claimed that the money had been given to the campaign behind his back; he was eventually acquitted by the Congress.
campaign to massacre the FARC, supposedly to denounce the state’s complicity with subversion. Simultaneously, a deep economic crisis erupted—an unfamiliar phenomenon, as the country had not witnessed this sort of severe downturn for three generations—with fatal effects, irreparably undermining the president’s popularity.

Why was the guerrilla response to Pastrana’s peace efforts so lukewarm? There are at least three complementary reasons. First, past experiences. The Unión Patriótica (UP), born from a similar process with the CP President, had been relentlessly destroyed and its leaders killed. Second, the military situation. The FARC had had spectacular successes in the field of battle in the previous year. In a longer perspective, it had been able to fulfill, almost step by step, its strategic objectives set out in its 7th Conference (1982). Under these favorable conditions, the FARC was more inclined to utilize both the demilitarized zone and the opening of negotiations to arm and reinforce itself rather than to make peace. And the decentralization process, which preceded the C1991 and was deepened by it, deeply changed the system of incentives that motivated the insurgents and the paramilitaries to wage their war. Until 1988, non-state combat organizations had several sources of funding: capturing rents from legal and illegal production processes (mining, marihuana, and coca), and kidnapping were the main ones. After that, “protecting” (in the mafia sense of protection as extortion) municipalities and subsuming them under their influence became a focal point of the non-state actors. The C1991 made local influence even more important, as the nation set aside three types of resources for its sub-national units (departments and/or municipalities): 1) fund transfers from the central government, many of them earmarked, for administration of and investment in health and education; 2) the right to levy several important taxes, including land, industrial, and commercial taxes; and 3) the right to charge certain royalties, for example, from mining companies.

Non-state organizations targeted weak municipalities and departments, characterized by a lack of or poor monitoring, feeble bureaucracies, and ineffective police forces. Additionally, putting a municipality under the influence of an armed group gave the group economic resources, power, legitimacy, and influence. By the mid 1990s, the guerrillas—mainly the FARC—were under the illusion that this type of local activity would give them strategic advantages. We use the word “illusion” because the guerrillas were not aware that paramilitary groups would be able to utilize a better version the same technique. Because the paramilitaries had many more direct links to regional rural elites and state agencies, they developed more effective, more stable forms of territorial control than the guerrillas: the defeat of innovators at the hands of crafty imitators.

Nonetheless, the FARC either read President Pastrana’s peace advances as a sign of weakness or as an initial overture that had to be answered by military pressure. The outcome was destabilization and the end of peace. In the meantime, Pastrana had launched several initiatives; of them, Plan Colombia was the most publicized. Initially, Plan Colombia was presented by Pastrana as a Marshall plan for the country, linking peace with development. However, the initial idea for Plan Colombia was transformed by a U.S. technical team into an anti-drug and military undertaking. Especially at the beginning of Plan Colombia, the preeminence of the military component was overwhelming. The modernization of the military was continued by Uribe (2002–2010), which has had a huge impact on reversing the fortunes of the adversaries in the Colombian war.

All in all, why were the many well-intentioned power sharing and peacemaking efforts effective not effective? The state started with big pluses: the support of a broad sector of the
population and a genuinely democratic program. Colombia’s program established adequate connections—in terms of language and proposals—with the main international trends and actors of the period. And it was supposed that the fall of the Berlin Wall would facilitate the surrender, or at least the reincorporation, of the guerrillas. However, the following conditions created serious roadblocks against peace:

1. The C1991 coalition was feeble, and after its dissolution, there was no set of actors at the national level capable of simultaneously pushing forward reforms in the constitutional spirit and winning the elections;  
2. The existence of huge, illegal rents that fueled both war and corruption, as well as some aspects of the very modernization of the state that supposedly were to act as anti-violence devices—especially decentralization, in the form it took—transformed the war and made it more difficult for the state to deal with using the methods of previous decades;  
3. The economic crisis and the violent response of the guerrillas to peace efforts critically weakened President Pastrana’s credibility;  
4. Given the instability of the peace process, its technical weaknesses (on both sides) and the U.S. orientation, with its focus on the war on drugs, the government was not able to convince the international community of the necessity of a plan linking peace and development.

CONCLUSIONS

Why was the Colombian state unable to attain and maintain control over large-scale violence? Economic outcomes on their own do not seem to provide specific answers to this question. If we consider the comparative economic performance between 1950 and 1998 (see Table) for seven Latin American countries, Colombia is neither the best nor the worst performer. Its GDP per capita growth rate is the most stable among the countries in the sample, perhaps a sign both of responsible monetary and fiscal policies and conservative approaches toward economic growth. So what can explain Colombia’s inabilities to produce a stable accord and to win its internal war? Four types of complementary answers can be offered.

First, unresolved structural factors, especially regarding land and property and the territorial reach of the state (Gutiérrez et al., 2008). While these issues remained in an “inactive” state during long periods, once they were politicized, they had explosive potential. The regular use of violence during Colombia’s long wave of expansion of the agrarian frontier plus the incorporation of large portions of the country by illegal substance markets generated large rent incomes from wide expanses in which the state was only feebly present (and where, due to demographics, there was no incentive for politicians to bring state control).

Second, certain institutional factors had negative effects. The notions that all good things come together and that success in one dimension entails success in all the rest should be banned from peace and development thinking. In reality, different types of “peace capital” are not easily convertible. A very good plan that yields some aspects of democratization may have nothing to do with conflict resolution. It also seems that timing plays a very, very important role. Key reforms, such as the agrarian one, should be pushed forward at a rapid pace (Berry & Cline, 1979); otherwise, they have diminishing possibilities of making a difference as time passes.

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84 This was not the case at the sub-national level. At least in big cities, some C1991 coalitions were able to do both.
85 Argentina, Brazil, Chile, Colombia, México, Peru, and Venezuela.
Third, a combination of both structural and institutional factors needs to be considered. It is essential to pay attention to pro peace and power-sharing coalitions and their conditions for survival (Yassar, 1997; Putzel, 2006). Some coalitions are likely to break down fast (such as C1991). Others have to be protected with a set of devices that may instigate new waves of violence. As both war and peacemaking trigger large-scale transformations of the state and society, the existence of cohesive, technically savvy political parties that hold their own during major social transformations appears to be a crucial variable for evaluating the odds in favor of long-term stabilization.

In this context, the role of international factors in the Colombian experience appears rather ambiguous. Nobody could reasonably deny the positive effects that many international pressures have had on the Colombian state. The obvious case is human rights. However, a whole set of anti-criminal, anti-corruption, and pro-state-building initiatives can be invoked, including the scaling of the capacity of the military. As seen during this narrative, many of the horrors of the Colombian conflict were caused by one or the other. Less prominently, there are some types of international influence that may have been positive had they not come in a formulaic form, which did not pay attention to the specifics of a country with the type of war Colombia was waging. Decentralization is the best example. All this said, until today even during the best international conditions—the 1966-1970 presidency—reforms conceived to effect simultaneously development, peace, and power sharing are difficult to implement. More than benevolent indifference may be needed.
Table 1. GDP Growth for a Sample of Latin American Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP per Capita (in 1990 US$)</th>
<th>GDP Per Capita Growth Rate (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>.987</td>
<td>7.973</td>
</tr>
<tr>
<td>Brazil</td>
<td>.672</td>
<td>3.882</td>
</tr>
<tr>
<td>Chile</td>
<td>.821</td>
<td>5.093</td>
</tr>
<tr>
<td>Colombia</td>
<td>.153</td>
<td>3.499</td>
</tr>
<tr>
<td>Mexico</td>
<td>.365</td>
<td>4.845</td>
</tr>
<tr>
<td>Peru</td>
<td>.263</td>
<td>3.952</td>
</tr>
<tr>
<td>Venezuela</td>
<td>.462</td>
<td>10.625</td>
</tr>
</tbody>
</table>

Source: Maddison (2006)

Table 2 A – Composition of the House in 1962** by Voting Bloc (N=89)

<table>
<thead>
<tr>
<th>Members of the FN coalition</th>
<th>FN dissidents</th>
<th>MRL “soft line”</th>
<th>MRL “hard line”</th>
<th>ANAPO</th>
<th>Movimiento Independiente Liberal</th>
</tr>
</thead>
<tbody>
<tr>
<td>55</td>
<td>1</td>
<td>22</td>
<td>9</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Gutiérrez (2007)

Table 2 B – Voting Scenarios in the House with the Preference Distribution

<table>
<thead>
<tr>
<th>Rules and Coalitions</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simple majority quota (45 votes), with any kind of distribution, as long as the FN members are disciplined</td>
<td>National Front (NF) coalition Banzhaf power index= 1 Banzhaf Power index of everybody else=0</td>
</tr>
<tr>
<td>2/3 quota (60 votes) with each bloc voting separately</td>
<td>NF bloc index=0.6 Movimiento Revolucionario Liberal (MRL, Liberal Revolutionary Movement, splinter group of the Liberal Party) soft=0.2 MRL hard=0.2 The others=0</td>
</tr>
<tr>
<td>2/3 quota with the MRL hues voting together</td>
<td>FN=0.5 MRL=0.5 The others=0</td>
</tr>
</tbody>
</table>

Source: Gutiérrez (2007)
Figure 1 – Evolution of the Gini Coefficient, 1975 – 2003


Note: As the Gini Coefficient increases, income inequality increases, and as it decreases, income inequality decreases.

Figure 2 – Weight of the Investment in Justice (lower dotted line) and in Defense (upper line) from 1950 until 2005

<table>
<thead>
<tr>
<th>Main Issues:</th>
<th>Policy Implications:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• During the 1958-2008 period, Colombia experienced a unique combination of competitive politics, peacemaking attempts and conflict.</td>
<td>• The prevalence of unresolved structural factors of state consolidation cannot be ignored.</td>
</tr>
<tr>
<td>• Colombia demonstrates that economic development is not sufficient for ensuring peacemaking: while the country has not lagged behind its neighbors in terms of development indicators, this has not proven to be enough to prevent violence.</td>
<td>• There has been a negative feedback between well-intentioned policies simultaneously implemented to address specific problems.</td>
</tr>
<tr>
<td>• The study challenges the most well-known explanations for the Colombian paradox, in order to suggest a different approach for understanding the country’s inability to simultaneously achieve the objectives of development, a transition to democracy and peace.</td>
<td>• Power-sharing coalitions striving to achieve peace require mechanisms to preserve themselves: i.e. programmatic and cohesive political parties as actors promoting change.</td>
</tr>
<tr>
<td>• More specifically, it compares two periods in Colombia’s history: the National Front (1958-1974) and the Post-1991 Constitution Reform. For both of them we consider the political context in terms of power sharing and peacemaking initiatives. We also extend this political context to the issues of economic/social development.</td>
<td>• Finally, the diverse interaction of actors, objectives and means has meant that Colombia has not enjoyed a set of international factors conducive to simultaneously achieving peace, democracy and development.</td>
</tr>
</tbody>
</table>
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World Bank. [used for Figure 1 data]


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Case Study: Lebanon
Samer Frangie and Nisreen Salti

INTRODUCTION

Lebanon may have featured as a textbook case of civil war and sectarian conflict, but it is less likely to get an entry in a manual for post-war recovery (Leenders, 2003).

In the last few decades, as civil wars have overtaken traditional state wars and have become the dominant form of violent conflict, Lebanon, with its history of a 15-year civil war, holds a wealth of lessons for anyone attempting to understand the social, political, and economic dimensions of conflict and post-conflict peace building. However, as every case of civil war is unique in some respect, and Lebanon does not deviate from this rule with its internal and regional specificities, the process of drawing general lessons from its experience, especially from its failures at enacting a sustainable post-conflict peace, is problematic. Before attempting to draw general conclusions from the Lebanese experience, a few remarks need to be made.

Firstly, the Lebanese civil war is an overlay of a multitude of conflicts, some of which bear the properties of any identity-based conflict and some are specific to the region’s history. Thus, the standard term “Lebanese civil war” is misleading and should be replaced, at least in readers’ minds, by “Lebanese civil wars.” So while sectarian strife was fed and fuelled by regional divisions and was the domestic reflection of regional schisms and underlying internal economic and class differences, and while intra-sectarian violence was rampant within most sects at various stages of the war, sectarian differences in the composition of the population remained the principal sources of tension in the war, or were perceived to be by the main players.

Secondly, the difficulty of establishing clearly the nature of the conflict and the main players is compounded by a problem of periodization, making the dating of the beginning and end of the civil war a matter of contention between the various interested parties. Despite the “official” chronology that established 1975 and 1990 as the two temporal extremities of the war, it should be widely acknowledged that violence did erupt before and after these dates, blurring the neat distinction between peace and war posited by the “official” account. These uncertainties pertaining to the characterization and periodization of the civil war are not simply academic subtleties but are reminders of the complexity of such processes and the difficulty of making comparison.

With these warnings in mind, the paper will deal with Lebanon’s experience in post-conflict peace building, taking as its starting point the Ta’if Agreement. Heralded as the accord that ended the war, the agreement formally divides political power equally between Christians and Muslims. Inside this general division, formal and informal subdivisions regulate the distribution of administrative and political power among the sects composing these two communities. The goal of this two-layer division was to separate the question of demographic weight from the issue of political representation by allocating equal general shares while opening the possibility for short-term and unofficial fine-tuning of this division of power. A series of constitutional reforms were enacted, under the watch of Syria, the main enforcer of the post-war settlement, aiming at creating the political and economic conditions for a sustainable peace.

87 The Document of National Accord or National Reconciliation Accord is more often called the Ta’if Agreement because it was negotiated in the city of Ta’if, Saudi Arabia in 1989.
Twenty years later, the results of such an experience are at best ambiguous and at worse, a clear case of failure. This chapter will investigate why such a system did not succeed in establishing a long-term peace, reproducing the state of sectarian tension that fuelled the civil war. This chapter is organized as follows: Section 2 provides a historical overview of power-sharing agreements in Lebanon. Section 3 describes the Ta’if Agreement and discusses the most relevant aspects of the agreement as well as the major players involved, both domestically and regionally. Section 4 surveys the steps taken toward decentralization and discusses the effectiveness of public and private actors at service delivery and the extent of participation and accountability in the post-war period. Section 5 turns to macroeconomic policy and briefly describes the history of macroeconomics in Lebanon, provides a quick sketch of the economic effects of the war, and then discusses at length the fiscal and monetary policies of the successive post-war governments in Lebanon. Section 6 concludes the chapter.

HISTORICAL BACKGROUND OF THE POST-WAR TA’IF REPUBLIC

Historical Background

Even before its creation as an independent state in 1920, Lebanon was ruled through power-sharing systems of governance. These governance systems were devised as systems of managing vertically divided societies and more specifically in the case of Lebanon, societies divided along sectarian affiliations.88 Sectarian power-sharing formulas had characterized the Lebanese system since 1840, or since what later came to be known as the roots of the modern Lebanese state. Prior to this date, a non-sectarian muqatajis system was in place, whereby “the overarching political factions dividing Mount Lebanon’s society […] were non-confessional clan-alliances, based on genealogical, local and personal loyalties” (Scheffler, 1999). The historical conditions surrounding the transformation of sectarian identity into the main structuring principle of the Lebanese political system are rooted in the developments that marked the nineteenth century.89 These factors coalesced, leading to the formation of a sectarian polity, institutionalized at first by the qāʾimmaqāmiyya system during the 1840s. This short-lived system was followed in 1861 by the Mutaṣarrifiyya system, extending in practice the sectarian logic to the whole administration. These early forms of sectarian governance set the bases for the future development of Lebanon’s governance structures.

Following the breakup of the Ottoman Empire, the formation of Lebanon and the establishment of the French mandate (1920–1943), a new political system was established, one

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88 There are currently 18 legally recognized sects in Lebanon. Even though the official political distribution of power caters for all eighteen recognized sects, the two main lines of division are (1) between the Christians and the Muslims and (2) within each religion the three main sects: on the Christian side, the Maronite, the Greek Orthodox, and the Greek Catholic communities, and on the Muslim side, the Sunni, Shiite, and Druze communities. The demographic weight of each community is a closely guarded secret. Any disclosure of official figures might threaten the tenuous distribution of political power, which explains why the last official population census dates back to 1932. Unofficial figures estimate the Christian share at 53 percent of the 1943 population, decreasing to 42 percent in the 1980s. See McDowall (1986, 9) and Chamie (1980, 177). Current unofficial estimates put the distribution of the population at 35 percent Christian and 65 percent Muslim.

89 These developments pertain to the Western, and especially French, growing political penetration of Mount-Lebanon, the economic and social transformations related to the silk trade, and the context of Ottoman reforms. For a more in-depth historical overview of the emergence of sectarianism and the sectarian political system, see Chevalier (1970 and 1971) and Trabulsi (2007); for a Marxian account, see Dahir (1986); for a post-colonial reading of sectarianism, see Makdisi (2000).
that retained the sectarian system of power sharing. The terms of the League of Nations’ Mandate for Lebanon explicitly guaranteed the autonomy of the religious groups in managing their internal affairs and maintaining their own educational systems.\textsuperscript{90} With the independence of Lebanon in 1943, the National Pact and Lebanese Constitution formalized the sectarian power-sharing formula. The National Pact is an informal division of political power among the diverse communities including, most importantly, between the Christian Maronites and the Muslim Sunnis, and, to a lesser extent, the Muslim Shiites, who despite their demographic power, were politically marginalized.\textsuperscript{91} This pact broadly sketches the rules of the political game: cohabitation and division of posts between communities internally and a neutral position toward international affairs. The Constitution states explicitly the rights of religious communities to exercise autonomy in the management of their internal religious affairs, personal status laws, and education (Articles 9, 10 and 95). During this period, the main characteristics of the political system were formalized: allocation of the presidencies of the Republic, the Council of Ministers, and the Parliament to the Maronite, Sunni, and Shiite communities respectively, division of the parliament along sectarian lines with a ratio of six Christians to five Muslims, informal division of the cabinet along sectarian lines, and the distribution of administrative posts by sects.

\textbf{The Civil War}

The successive refinements of the power-sharing system after Lebanon’s independence were not enough to stop the country from descending into a long and bloody civil war. The 1975–1990 civil war was seen by many as a sign of the failure of this manner of managing divided societies. The underlying rationale of power-sharing systems is to represent the various relevant groups politically, as a way to mitigate potential conflicts and to reduce the possibility of sectarian domination. Nevertheless, these arrangements face a number of pitfalls, such as the inability to centralize decision making, a lack of flexibility, the fragility of an uncertain system, the need for international arbitrage and external players to regulate conflict, the propensity of domestic parties to question the power-sharing agreement, and the self-perpetuating character of this system. The civil war indicated that the Lebanese power-sharing system failed to avoid these pitfalls. Instead of mitigating the causes of earlier conflict, this system exacerbated them.

Even though the Lebanese civil war signaled that the existing power-sharing system was deficient, the causes of the war were not solely related to inter-sectarian dynamics. Regional elements played important roles in igniting the civil war, subjecting the Lebanese system to pressures it could not handle. The Arab-Israeli conflict, the presence of the Palestinian resistance movement, and the regional ‘cold war’ that was being fought mainly in Lebanon between a pro-West Christian right-wing alliance, supported by Israel, and a pro-Palestinian Palestine Liberation Organization (PLO) alliance, supported by the pro-Soviet Syria, were all elements that contributed to the fueling of the civil war. Taking these factors into consideration, the Lebanese system was unable to deal with regional tensions because of its internal sectarian problems.

The system was historically biased toward the Christian communities, providing them with a disproportionate share of the political power. The unequal distribution of power was a recurrent source of disputation by the Muslim communities, at that time comprising a majority of

\textsuperscript{90} For the Mandate period, see Trabulsi (2007), Zamir (2000), Rabbath (1973), Thompson (2000), and Firro (2003).

\textsuperscript{91} Although the accounted for 30 percent or more of the Lebanese population as early as the mid 1960s, only 20 percent of parliamentary seats were held by Shiites (Norton, 1985).
the population. This internal source of political conflict proved to be a perfect cover for regional players to intervene in the civil war, pushing local political players to seek outside support.

The unequal distribution of political power was mirrored in the social and economic domains. The modern history of Lebanon, at least until the civil war, was characterized by a socioeconomic inequality skewed in favor of Christians, albeit decreasingly so over time. On most of the socioeconomic indicators, the Christian communities fared much better than their Muslim counterparts. From education to occupation and income indicators, the sectarian ranking was the same: at the top the non-Catholic Christians, then Catholic Christians, followed by the Druze, the Sunnis, and, at the bottom of the ranking, the Shiites. For instance, whereas the average family income for the Christian sects was approximately 7,100 Lebanese Liras (LL) in 1971, it stood at 5,400 LL for the Muslim sects (Chamie, 1980). The economic and social power of the Christian sects was similarly illustrated in their superior representation in the highest earning professions: Christians represented in 1981 around 71 percent of bankers, 73 percent of insurers and insurance brokers, 71 percent of lawyers, and 68 percent of medical doctors (Labaki, 1988). Emerging radical parties in the 1960s capitalized on a pool of disenfranchised populations, predominantly Shiite and Palestinian, and to a lesser degree, Sunni, easy to mobilize with political discourse articulated around sectarian identity.

The linkage of socioeconomic inequality with sectarian affiliation was considered one of the main causes behind the civil war and the breakup of the social contract. Inequality can act as a driver for group mobilization that increases the probability of violence, and when sectarian divisions are entrenched, conflict is more likely to occur. Though these socioeconomic factors need to be taken into account in explaining the war and the possible relapse into conflict, as Cramer has noted, there is no straightforward empirical link between inequality and war (2003). It is clear that socioeconomic considerations played a role in the decision-making process of individuals or groups about entering armed conflict. Nevertheless, it is unclear through which process these macro-descriptions of inequality translated into individual decisions on entering or exiting a war. Moreover, as the civil war developed into an intra-sectarian war that did not correspond with socioeconomic fault lines, such arguments could not explain the war. Inequality was measured across sectarian groups and was often thought to explain the animosity between Muslims and Christians, due to the dominant role of the latter. But during the 1980s, the civil war gradually turned into a conflict within various sectarian groups rather than between two sectarian groups. The Christian camp was divided by bitter struggles during much of the civil war, leading to some of the fiercest military conflicts in the late 1980s. The Shiite camp was similarly divided between two political parties, who clashed violently at the end of the 1980s. During the 1980s, the war became a series of conflicts between groups that belonged to the same socioeconomic category and the same religion. It is an accepted fact that high levels of poverty and inequality are more conducive to conflict than a just and prosperous society. This tendency is heightened when poverty and inequality are mapped onto ethnic, sectarian, or religious cleavages. Yet, the Lebanese civil war does not support more precise extrapolations regarding this relation.

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93 The Lebanese Lira corresponds in nominal terms to roughly USD 0.30 during this period.
95 This ‘grievance’ hypothesis might have played a role in igniting the civil war, but, as Makdisi and Sadaka (2005) confirm in testing the Collier and Hoeffler model of greed and grievance in the case of Lebanon, it was ‘greed’ factors that helped perpetuate the war, in the forms of militias, smuggling, and illegal activities.
Pre-‘Ta’if Republic’ Socioeconomic and Political Situations

The post-war settlement recognized some of these complexities, while ignoring others. The dominant narrative of the war pinned the blame of the war on sectarianism and the inability of the state to correctly represent the underlying sectarian balance of power. As a result, an updated version of the sectarian power-sharing formula, the Ta’if Agreement, was put in place at the end of the war. The goal of this new version of the power-sharing agreement was to establish a more representative political and institutional system, one that would correct some of the previous bias. In this respect, the Ta’if Agreement tried to mirror the results of the civil war but also of the social change of the second half of the twentieth century.

The Ta’if Agreement came after 15 years of civil war and more than four decades of social change since the previous power-sharing scheme. The trend toward socioeconomic equalization started with Muslims becoming a demographic majority prior to the war. The period from independence to the Ta’if Agreement saw the economic and social rise of the Muslim communities, challenging the Christian prominence that marked the first decades of Lebanon’s existence. This sectarian balancing of social and economic power had a number of causes. Domestically, the successive policies of ‘balanced development,’ especially during President Fuad Shehab’s mandate (1958–1964), improved Muslim access to public-sector employment and education. Moreover, changes in the regional economies, with the rise of the Gulf area as a major economic player, propped up the role of the Sunni community. Similarly, as increasing numbers of Shiites immigrated to Africa for employment, their remittances provided a source of capital accumulation to the Lebanese Shiite community. The civil war itself brought about social changes, giving an added impetus toward sectarian balancing, as alternative urban centers were built after Beirut was divided into two areas, each dominated by contending political forces. In addition, illegal activities proliferated to meet the demands of the various militias.

These social, political, and economic changes affected the composition of the ruling elites, further fragmenting them. The emergence of new sources of social power and the diffusion of influence among a larger number of elites created alternative sources of power with wider, sometimes contradictory, interests and constraints. The political elite often clashed, based on shifting clientelistic alliances among members of various groups. However, their disparate political and social bases made their diverging interests deeper sources of conflict that often could not be resolved through traditional negotiations and compromise.

Members of political elites learned lessons from the civil war in Lebanon, and political and social scientists observed social changes that affected the population in the second half of the twentieth century. They all pointed to the same conclusion: the Lebanese system needed to be recalibrated to be more inclusive of the new social groups and more representative of their newly acquired power. The pre-war centralization of power at the apex of the Lebanese state was seen as a cover for Maronite domination and needed to be replaced by a more representative system of decision making. The Lebanese laissez-faire attitude toward socioeconomic questions was deemed insufficient to equalize the socioeconomic characteristics of sects, and an awkward system of redistribution would take its place. Lastly, Lebanon’s flirtation with a neutral stance regarding the Arab-Israeli conflict and the various regional powers would vanish under Syria’s

96 According to Leenders, four main groups provided the bulk of the political representatives during the post-war period: Syrian clients, ex-militia members, business interests, and the traditional notable families or zu’ama. For more details, see Leenders (2007).
yoke. The new understanding of power-sharing governance following the war would reflect these transformations, requiring the state to be more inclusive of the various social groups, to intervene to improve socioeconomic conditions for the disadvantaged, and to be more dependent on its Syrian guarantor.

THE ‘TA’IF Republic’

The Ta’if Agreement

The ‘Ta’if Republic’ provided the following rules of the game for the post-war period: (1) the codified rules for the division of power, (2) the customs and practices regulating the distribution of power, and (3) the various mechanisms devised to implement and bypass this distribution. The first element of these rules was to make the state more dependent on the goodwill of the underlying sects. The fragmentation of the polity and the demands for broader distribution of power were embodied in the text of the Ta’if Agreement in the form of a spreading or sharing of political power and institutional prerogatives. At the executive level, a great deal of power was shifted from the Maronite President of the Republic to the Sunni Prime Minister and to the Council of Ministers, which was transformed into a collegial body exercising power through consensus. In addition, the legislative branch, the Parliament, was strengthened and shielded from any real threat of dissolution by the executive branch. A system of vetoes and checks and balances was introduced among these three main leaders (also called presidencies), leading to the necessity of including all the main players in the decision-making process. These institutional changes reflected the lessons drawn from the civil war and the inadequacies of the previous versions of the power-sharing agreement. To mitigate the possibility of a domination of the state by one sect, the decision-making process was spread out among the three presidencies, linked to each other through a web of checks and balances that would make the inclusion of the representatives of the three main sects necessary for any decision. And to represent more accurately the changing political power of sects, the Maronite presidency was weakened, and the Sunni premiership and Shiite speaker of the house of parliament strengthened.

But this attempt at averting the subversion of the power-sharing system through the monopolization of power by one group led to another form of subversion, one characterized by the transformation of the already weak Lebanese state into a conditional and dislocated state. The requirements of the Ta’if Agreement conditioned the state on the goodwill of the underlying social forces, thus institutionalizing the ‘Migdalian’ conditions of a weak state (Migdal, 2001, 2008). While all states are conditioned on the periodic approval of their underlying social forces, the post-war period instituted a system whereby Lebanon became dependent on the constant approval of the main social forces, removing any limited autonomy one branch might have had regarding the underlying balance of power. The conditionality requirement of the Ta’if Republic spread political power as thinly as possible among the various political groups and informally allocated certain state institutions to sects, providing them with a de facto veto power on major

97 For an overview of the constitutional changes of the Ta’if Agreement, see Sleiman (1994).
98 For instance, the procedure for the transfer of laws between the Council of Ministers and Parliament allows the speaker of Parliament to delay indefinitely the draft laws proposed by the executive branch, providing him with stronger bargaining power than the executive.
Each institution enjoyed the relative autonomy afforded by its political protection in the consensus prerogative that dominated the overarching political game.

This sectarian assignment of executive portfolios, often with overlapping mandates, led to a fragmentation of the state into separate entities dominated by political players, a duplication of work, and deadlocks when interests clashed. Thus, conflicts among political actors devolved into conflicts between institutions, and political ententes became institutional alliances. Institutional feuding became the norm, as institutional checks and balances gave way to concerns of consociational imperatives for the sake of stability. Political stability was often ensured at the expense of other institutional goals, such as efficiency, sound policy, or cost reduction. The strict conditionality of state institutions caused the post-war Lebanese state to function rigidly, transforming the smallest decision into an inter-sectarian bargaining game and undermining the unity, coherence and legitimacy of the state.

The second element in the post-war rules of the game pertains to the various political and institutional mechanisms devised to resolve the tensions of sectarian representation and help institutions run more efficiently. In order to fill the gaps resulting from the agreement, to implement part of it and to bypass momentarily the requirements of sectarian representation, extra-institutional fixes were introduced and quickly became part and parcel of the domestic political structure. These fixes were not codified. Rather, they bypassed the state altogether, attesting to the institutional multiplicity characterizing the constitutive matrix of state institutions. This lack of codification, impossible in some cases or left out purposely in others, resulted in agreements of a short-term and uncertain nature. Dependent on a changing balance of power between the main political players, these mechanisms were like snapshot images of the relations among the various elites. This uncertain, changing environment brought about bargaining and negotiations as the modus operandi of the Lebanese system. In the context of a weak state and a precarious political settlement, negotiations emerged as one way of managing the political tensions and controlling the various players.

The negotiations, even though necessary to deal with the institutional rigidities of the sectarian conditionality, provided only short-term relief for the Lebanese state, undermining in the long-term its coherence and strength. In this institutional framework, most political mechanisms and boundaries were subverted to cater to one of two goals, making the state more coherent or stronger. For instance, the Council of Ministers was transformed from a collective decision-making body into an arena for sectarian bargaining, with ministers acting as the guardians of their particular communities (Salam, 2003). From the distribution of public employment to urban planning changes, each attempt at changing the underlying property rights structure was an occasion for political conflict that could last from a couple of days to a year. The boundary between public and private, already blurred in Lebanon, lost any relevance in the post-war period, as it was crossed by most political players. Sectarianism provides a convenient

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99 Thus, the Council for Development and Reconstruction (CDR) was reactivated and placed under the aegis of the late Prime Minister Rafik Hariri, the highest Sunni representative in the state. Public investment in the South was channeled through the Council of the South (CS), which came under the control of the Parliament’s speaker of the house, Shiite leader Nabih Berri. The Ministry and Central Fund for the Displaced (CFD) were established to ensure the return of the displaced and were awarded to the main Druze leader, Walid Jumblat. Other executive cabinets were also parcelled out to smaller factions.

100 For a selected review of the main political crises during this post-civil war period, see Debié and Pieter (2003).
Syria

One of the main factors in the process of dislocation of the state was the role played by Syria in the post-war period. Syria emerged at the end of the civil war as the main powerbroker in Lebanon and the enforcer of peace in the fragmented society that emerged after the civil war. The difficult application of the Ta’if Agreement and the various zones of uncertainty in the agreement, in addition to Lebanon’s underlying political conflicts, required an enforcer, a role Syria was more than willing to fulfill with full regional and international cover. However, Syrian intervention developed in the 1990s to encompass almost every decision taken by the Lebanese state. From a temporary enforcer of a regional consensus, Syria’s role extended to become the sole player in Lebanon. Far from being a benevolent enforcer, Syria played on the fragile peace and inconsistencies of the power-sharing agreement to strengthen its hold on political life in Lebanon. By reproducing and increasing the arbitrariness and uncertainty of the system, Syria increased the dependence of Lebanese political players on its goodwill. Moreover, by blocking and repressing any attempts at Lebanese rapprochement, Syria reproduced the state of fragmentation and blocked the possibility of the emergence of a domestic consensus that could have reduced the dependence of the Lebanese system on an external enforcer.

Syrian intervention is illustrated in the gerrymandering of electoral laws. Post-war elections, for instance, lost their significance as a process of aggregation and selection of political preferences; they were transformed into an inter-elite rivalry for Syrian favor. The political meddling by Syrian intelligence removed any pretence that these elections were free or fair, transforming them into a “social event devoid of political substance” (El-Khazen, 2003). As such, the enforcer reproduced the conditions justifying the need for it, blocking the possibility of a sustainable peace that would render its presence unnecessary. Such interventions had their financial and economic counterparts in the form of the corruption that developed around the Syrian sources of political power. Corruption flourished in post-war Lebanon, with a detrimental effect on the state budget and the business environment. It is very hard to quantify the extent of corruption and of its costs, but most economists agree that corruption increased drastically in the post-war period. This corruption was supervised by Syria, the highest political authority in Lebanon, and benefited Syrian politicians or their Lebanese clients. As Faddoul points out, major cases of corruption involved Syrian officials or Lebanese officials protected by Syria: international communications, oil traffic, and free zones in the airport and international harbors. As such, the role of Syria in the post-war period in enforcing the precarious peace

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101 For instance, Hariri’s strategy for shielding institutions involved placing his allies in top state institutions. Hariri managed to protect these institutions through extra-institutional negotiations and kickbacks that were often corrupt. Ignoring the spending patterns of one institution or awarding contracts to friendly politicians were sometimes the only ways to shield the institutions Hariri was responsible for from outside political interference. See Denoeux, G. and R. Springborg (1998).

102 As a sign of the political insignificance of these elections, boycotts and low participation rates marked the various elections that took place during the post-war period. Whereas the elections in 1968 and 1972 had a voter turnout of more than 50 percent, the elections in 1992 barely reach a 30 percent voter turnout, rising to almost 40 percent in 2000 (p.64).

103 For examples of the main cases of corruption, see Faddoul (2004).
that dominated the 1990s was at best ambiguous, enforcing some stability while reproducing the underlying conditions of instability and conflict.

Political legitimacy, which in Lebanon takes the form of sectarian legitimacy, and institutional efficiency clashed in post-war Lebanon. But the mechanisms deployed to ensure them led to the same conclusion, the fragmentation of the already weak Lebanese state. Conditioning state institutions on sectarian approval or bypassing state institutions for short-term institutional efficiency removed any pretense that the Lebanese state might be the central locus of power and fragmented whatever consistency might have survived from the civil war. The only constant in the post-war period has been this process of weakening of the central state, with disastrous political consequences, illustrated by the threat of a constant relapse into a civil war, the failure of effective decentralization, and the absence of efficient service delivery, to which we now turn.

SERVICE DELIVERY AND DECENTRALIZATION

State building, institutional consolidation, and decentralization

The imperative of peace building was resolved in the post-war period by sacrificing the goal of institution and state building. Redistribution was closely linked to rampant corruption and the collapse of public offices into the private individuals who held them. Similarly, the need for political flexibility to deal with the changing political environment was often secured through ad-hoc measures that contradicted the goal of the creation and consolidation of institutions. In such an institutional context, it was not a surprise that the administrative reforms, such as decentralization, were doomed from the start.

The debate on administrative decentralization has always been very thorny in Lebanon because many perceived it as a step toward federalism along sectarian lines. As such, political parties, often Christian, that have been ideologically prone toward political decentralization have called for administrative decentralization as a first step. The calls for decentralization have come up against the political stigmas associated with the notion of federalism, particularly given the country’s sensitivity about its existence as a unified entity, based on the contentious borders drawn by the French mandate in 1920 and in the wake of the geographical rifts and divisions born in the civil war. The terms of the debate regarding decentralization have been framed by the tensions between the efficiency and responsiveness of a decentralized administration and the danger of political fragmentation.

The principal official step taken toward decentralization were the municipal elections of 1998, which were the first municipal elections in 35 years. However, this vertical transfer of power was ineffective: limited municipal revenues meant political weakness and only perfunctory administrative power, and the absence of a sustained grassroots demand for participation and local governance meant the central powers would not be seriously challenged. In the absence of grassroots movements pushing toward decentralization, municipalities have become apparatuses of the local powerbroker, dependent on the goodwill of the politicians in the capital to ensure even minimal funding. Similarly, the policies of weakening trade unions and excluding them from the social dialogue has meant that whatever economic policies are to be adopted will not be influenced by trade unions or professional syndicates and organizations.

However, at the same time, a different, more perverse, form of decentralization, more akin to fragmentation, did take place. Horizontal decentralization came as a result of the tensions
between representation and efficiency and sought to shield institutions from the general dynamic of contestation and bargaining. This strategy was consistent with the post-war political settlement, and the ethos of the rule of one of the most prominent post-war prime ministers, Rafik Hariri, who sought to create new channels for executive power to avoid the post-war consensus-based regime, even where these created channels duplicate existing institutional structures and mandates. Hariri’s strategy of shielding institutions took various forms from privatization to political control. Most of these mechanisms violated the ‘good governance’ requirements, often deploying corruption or illegal means to secure the political pre-conditions of efficiency. This resulted in various combinations of Hariri’s apparatuses sometimes superimposed on the state, sometimes replacing it. The tactic resulted in some efficiency gains; however, in the long run it contributed to the general fragmentation of the state, creating institutions that became dependent on the general pattern of political conflicts, clientelistic networks and parallel administrations.

Service delivery

The blurring of the public-private divide is a primary characteristic of service delivery in Lebanon. The vibrancy of the private sector and the historically minimal state have meant that service delivery has been as much a private sector prerogative as it has been a part of the public sector. The institutionalization of the imperative of sectarian representation in the post-war period without regulation led to a multiplicity of modus operandi within state institutions. This multiplicity was rooted in the texts of the Ta’if Agreement and the Lebanese Constitution. In the presence of a weak state unable to regulate multiple institutional systems, this imperative was quickly subverted into a means for clientelistic redistribution and institutional capture.

Institutional infighting became the norm in the relationships between institutions. It was the triangle of the Hariri-controlled Ministry of Finance (MOF), the Berri-dominated Council of the South (CS), and the Jumblat-led Central Fund for the Displaced (CFD) that witnessed the heaviest fighting. Prevalent mostly in the institutions dependent on the prime minister and in strategic institutions, such as the VAT directorate and the Ministry of Finance, this practice aimed at providing ‘private-public’ servants who would be shielded from political bickering.

104 Riad Salameh, Hariri’s account manager at Merrill Lynch, was appointed governor of the Central Bank; Fuad Siniora, CFO of Hariri’s enterprises, was selected as minister of finance; Suhail Yamut, former director of Hariri’s business interests in Brazil, was named governor of Beirut; the presidency of the CDR was given first to El Fadl Chalaq, former chairman of Hariri’s company, OGER, in Lebanon and board member of Hariri’s private charity, then to Nabil el-Jisr, former president of OGER in Paris. For a full list of Hariri’s allies, see Iskandar (2006, 74-79).

105 This mechanism was extended legally through the increased use of United Nations and World Bank consultants to assist the administration in capacity building, practically creating a parallel administration (Nahas, 2006, 107-8). Prevalent mostly in the institutions dependent on the prime minister and in strategic institutions, such as the VAT directorate and the Ministry of Finance, this practice aimed at providing ‘private-public’ servants who would be shielded from political bickering.

106 A similar strategy has been used in Brazil, according to Evans: “Unable to transform the bureaucracy as a whole, political leaders tried to create “pockets of efficiency” within the bureaucracy . . . thus modernizing the state apparatus by addition rather than transformation” (1995, 61). Even though these pockets of efficiency were more developmental than the rest of the administration, this strategy had a number of disadvantages. First, these pockets were dependent on the personal protection of political leaders to resist the encroachment of the rest of the administration. Second, this approach made strategic selectivity harder, leading to an uncoordinated expansion of the administration and to a weakening of the organizational coherence of the state apparatus, leading to the emergence of “an ever more baroque structure.” In addition, the careers of the bureaucrats were not geared toward long-term gains, as they were dependent on the changing political environment (1995, 62-3).

107 After allegations of corruption and mismanagement, Jumblat and Berri counterattacked by asking for the abolition of the Council for Development and Reconstruction and the Organisme de Gestion et d’Exploitation de
effectiveness and further weakened its unity. At the same time, the state’s service delivery suffered from political appropriation, causing duplication and loss of efficiency. Even though the quantity of services was not necessarily affected by institutional inefficiency, delivery of services to the needy was greatly diminished, rendering the system financially untenable and socioeconomically defunct.

MACROECONOMIC POLICY

Historical overview

Lebanon has always had a liberal economic system, with a vigorous private sector serving as its foundation. Unlike most neighboring countries, laissez-faire in Lebanon was never seriously contested, and the state remained minimal, as the country benefited through the decades of the 1950s and 1960s and into the early 1970s from capital inflow via oil rents from the economies of the Persian Gulf, capital flight from state-controlled neighboring economies, and remittances from the Lebanese diaspora. Banking, trade, and tourism flourished. The liberal market economy was made possible by the traditionally influential business class, whose members had close ties to the political elite, individuals who made economic policies and conservative fiscal and monetary policies—all of which fostered a laissez-faire environment that benefited the business class.

The civil war resulted in the destruction of much of the country’s physical and human capital. The physical damage from the war was estimated at around US$25 billion. Estimates of human losses range from 90,000 to 170,000 (from 3 percent to 5 percent of the population), with another 300,000 injured, 800,000 displaced (one in every four Lebanese), and 550,000 to 880,000 emigrants. Lebanon came to rely more and more on remittances from its citizens who lived and worked outside the country (World Bank, 1995). The destruction did not spare basic infrastructure: one third of the phone lines and one third of power capacity were out of commission, 80 percent of the water supply was polluted, and water treatment facilities were seriously damaged (World Bank, 1995). Private sector efforts gradually substituted for public institutions’ services as the scope and capacity of government disappeared.

POST-WAR FISCAL AND MONETARY POLICIES

Assessing the successive post-war governments’ macroeconomic policy records reveals two prominent features: macroeconomic policy, particularly as it related to redistribution, was subordinated to the power-sharing agreement and the need for sectarian balance; however,

l’ex-société Radio-Orient (OGERO), institutions controlled by Hariri (an-Nahar, October 17, 1996). In 1998, a new crisis emerged between Hariri and Jumblat on the payment to the CFD (an-Nahar, June 26, 1998). At the end of 2001, the CS came under attack from the government. A campaign by Berri’s allies started in 2001 and ended in 2002, with the defeat of the government (an-Nahar, October 26, 2001 to February 25, 2002). The CS remained, but with limited funds; thus, a new crisis between the CS and the MOF emerged (an-Nahar, May 1st 2002 and May 2nd 2002). MOF funding of the CS was stopped due to the political conflict between Berri and Hariri. In 2006, the prime minister again tried to abolish the CS (an-Nahar, September 18th 2006). The CS responded to its detractors by taking credit for ending the Israeli occupation. The head of the CS accused the U.S. ambassador of instigating the campaign to close it (an-Nahar, August 11, 2005). Similarly, Hariri’s protection of the Council for Development and Reconstruction was not left unchallenged. During the post-war period and especially after the fiscal crisis became a recognized reality, the drive to reduce state expenditures added to existing tensions among institutions.
because the parties slicing the pie were identity-based rather than political in nature, macroeconomic policy was more focused on the relative sizes of the shares and less concerned with a vision for sustained development. Post-war economic strategy effectively centered around two policies: an ambitious public spending program and a stable exchange rate. The first of these policies, the government’s fiscal choices, turned out to be costly, particularly as the economy was trapped in a deficit spiral. It tied the government’s monetary hands, threatening to undermine its ability to maintain the second of its goals, a stable exchange rate.

**Fiscal policy: From reconstruction to debt management**

The hallmark of the post-war fiscal profile of Lebanon is one of sharply rising public debt in both absolute and relative terms. In 1992, the government embarked on a plan of reconstruction, with a sectoral and regional expenditure program of over $14 billion over the ten-year period between 1993 and 2002 that was intended to double per capita GDP. However, the plan was quickly abandoned because of its overly ambitious goals and unrealistic predictions.

As one of the platforms of the Hariri government of the early 1990s, which brought him into power at a time of financial crisis, was the anti-inflationary policy of pegging the currency, the government refrained from engaging in inflationary finance. When aid projected by the Ta’if accords failed to materialize (Gressani and Page, 1999), Lebanon’s budget deficits were financed by the government borrowing from the domestic banking industry, which enjoyed tremendously high interest rates on treasury bills. It is estimated that by the end of 1997, foreign financing of the reconstruction plan amounted to US$4 billion, of which only half a billion constituted grants; the remainder were soft and commercial loans (Wetter, 1999).

The years to follow would see a significant reduction in the share of foreign grants and loans in reconstruction expenditures. The cumulated deficits gave rise to a growing public debt that climbed from 48 percent of GDP in 1992 to 178 percent of GDP in 2005 (MMK, 2008).

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<th>Table 1: Fiscal profile 1992–2007 (in % of GDP)</th>
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<td>Expenditures</td>
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<td>o/w in foreign currency</td>
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Sources: Gaspard (2004) and IMF (2008). Note: The abbreviation o/w means “of which”.
While the expenditure side of the deficit saw large and growing government outlays, the government’s budget also came under pressure from the revenue side: Lebanon entered several trade agreements that would greatly reduce tariffs. The IMF estimates that in 2001, close to 72 percent of total government revenues came from taxes. Of these, import duties constitute the largest share (Table 2). The pressure to liberalize trade meant a significant reduction in government tax revenue, as import duties constituted 37 percent of government revenues in 2001 (LEA, 2008).

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<th>Table 2: Revenue structure (in % of GDP)</th>
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<td>Taxes on goods and services</td>
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<td>Import duties</td>
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**Monetary policy: Currency stabilization amidst deep dollarization**

Monetary policy centered on the stabilization of the nominal exchange rate. Thus, the ethos of the Central Bank’s policy, as expressed by Nasser Saidi, vice-governor during much of the post-war period, was that “monetary policy should aim to control inflation through control of money growth. The Central Bank should not become a reconstruction or development bank” (Saidi, 1999).

Currency stabilization required abundant foreign reserves for what at times was sustained intervention in the foreign exchange market by the Central Bank. The high real interest rates on treasury bills—where the cumulative premium of Lebanese treasury bills over foreign-denominated Eurobonds reached 54 percent—not only accommodated budget deficits, they also protected the Lebanese pound. However, the combination of a growing public debt and high real interest rates resulted in economic slowdown and sluggish growth. The Central Bank’s ability to prop up the Lebanese pound came under serious threat when, in addition to economic stagnation, the country suffered political and security shocks in the late 1990s and the early 2000s.

Monetary policy also relied on foreign donors and depositors, who supplemented the Central Bank’s reserves and effectiveness by restoring confidence in the currency and averting the danger of a currency crisis. The international donor conferences convened by the Lebanese government, starting in 1998, saw increased *domestic* support for the financial stabilization plan as well, as financial players in the country, like the Central Bank and Lebanese commercial banks, offered concessionary loans to finance the public debt (Dibeh, 2007).

The congruence of interests among the three sets of players, the state, the Central Bank, and the commercial banking sector, is thought to be responsible for the remarkable success of the currency stabilization policy despite conditions of extreme economic and political adversity at times. In 2004, the IMF concluded, “Lebanon has defied pessimistic predictions, including those of the Fund, and a debt crisis has been avoided. While investor confidence plays a role in any
emerging market economy, in Lebanon it has become the linchpin of a unique symbiosis between the public-sector and the banking sector balance sheets and how the authorities used this to overcome the near roll-over crisis of 2001-2002” (IMF, 2004). Credibility was key to the success of monetary policy: credibility was crucial for the Central Bank’s intervention to be effective at any point in time, and the more confidence the economic players had in these interventions, the less costly they were for the Central Bank. The perceived independence of the Central Bank, its apparent distance from the political pie-slicing exercises that plagued the government’s executive branch, and its steadfastness in preserving the value of local currency played a central role in curbing inflation and in limiting capital flight even during political and security crises.

**Macroeconomic policy within the power-sharing rules**

The fiscal, monetary, and exchange rate policy packages adopted by the successive post-war governments were shaped by the power-sharing agreement that brought an end to the conflict. While these policies contributed to stability, peace, and the consolidation of the power-sharing rules after the war in the short run, they did not encourage sustainable, long-term development. How did the macroeconomic decisions of the government contribute to the credibility of peace? First, fiscal policy was not chosen according to first-best policy options, so optimality from the perspectives of sound policy and good practice was compromised. The precariousness of peace and the imperative to uphold the power-sharing agreement dictated a departure from optimality. Rather, fiscal policy followed, at least on the spending side, a distribution rule that preserved sectarian stability and peace at the macro level by allocating funds according to the composition of the overall population according to confessional identity (Salti and Chaaban, 2010). The ethos of spending rules mirrored closely the culture of the Ta’if Agreement, which sought to redress weights in the power-sharing scale, thereby entrenching consociational balance as the only way forward in matters of governance and public choice. Within the set of fiscal outcomes that would satisfy the constraints of sectarian balance, which were the policy packages that ended up being chosen? The particular fiscal choices made at that time reflected the hallmarks of the post-war era: rampant corruption and the collapse of public offices and institutions into the identities and practices of the private individuals that held them.

We identify three broad implications of the subordination of fiscal decisions to the political power-sharing game within the context of a fragile post-conflict agreement. The first is that fiscal policy was not economically sound because it subscribed to power-sharing constraints that generally ruled out first-best policy options. The second is that the primacy of political power sharing in fiscal decisions made fiscal policy especially vulnerable to corruption and clientelism; fiscal decisions often devolved into a tool to slice the pie amongst political stakeholders. The third is that the fiscal game fortuitously contributed to solidifying the power-sharing agreement and to maintaining a peaceful equilibrium, though unfortunately at the cost of further entrenching a political culture of corruption and clientelism.

Assessing the effectiveness of fiscal spending, we find that cost recovery remains very poor. The US$8.5 billion incurred in expenditures in the first decade after the war was not sufficient for the completion of the projects undertaken. Nearly one quarter of government investments were disbursed in electric utilities and telecommunications, while these sectors’ performances remain largely inadequate (World Bank, 2005). Similarly projects to reconstruct
and rehabilitate the major road networks suffered from poor follow up and practically no maintenance, resulting in wastage of substantial funds.

The imperative of redistribution, codified in ‘Article G’ of the Lebanese Constitution, was reflected in the spending allocation of the initial reconstruction plan.\textsuperscript{108} The double aims of public spending, namely the sectarian imperative of equitable distribution and the socioeconomic need for efficiency, led to high levels of waste, political bickering, duplication of efforts, and lack of coordination among state institutions.\textsuperscript{109} Left to practice, the first imperative often prevailed; according to a recent CDR report, the duplication of equipment among regions is one of the most costly illustrations of this understanding of the notion of balanced development.\textsuperscript{110} Similarly, Salti and Chaaban’s research illustrates the dependence of public social spending on sectarian requirements, with the satisfaction of this imperative creating a heavy negative impact on the efficiency of social spending (2010).

In contrast, Lebanon’s post-war experience holds a somewhat uncontroversial answer to the question, “What should the priorities of monetary policy be in support of conflict resolution and peace?” The monetary policy that contributed the most toward maintaining peace as well as allowing key stakeholders to make private gains from public choice was the priority of exchange rate stabilization. In many ways, those playing the monetary game were immune to the customary political feuding surrounding public decision making in Lebanon, but they understood the feuding relegated to the next stage of the game: divvying up the funds procured through the treasury bills market.

One of the pitfalls of the mix of fiscal and monetary policy is that even though they provided a mechanism to translate Ta’if socially (fiscal) while ensuring a certain financial stability (monetary), the mix was not able to generate sustainable economic growth that could bring about increased standards of living and employment. Deviations from the optimum policy path have been tolerated, as they have often been imposed by the requirements of social peace and expediency, but policy choices also need to contain a long-term dimension. A balanced growth path would not only contribute to solidifying the peace, it would also free the state from the clientelistic web of resource redistribution.

\textbf{GENERAL CONCLUSIONS}

Lebanon provides a good illustration of the pitfalls and dilemmas associated with power-sharing agreements, having always been governed by variations of this system of rule. The litmus test of a power-sharing agreement is whether it provides the basis for an enduring peace. Clearly, the civil war signaled the failure, albeit partial, of the pre-war power-sharing agreement to contain rising tensions and avoid a descent into civil strife. And as mentioned above, the Lebanese political elites deduced three lessons from this failure. The first lesson is that the centralization of


\textsuperscript{109} The scattering of expenditure on education among different institutions, such as the Ministry of Education, the CS and the CDR illustrates the waste that results from the lack of coordination and duplication among state institutions. For instance, all three of these institutions have spent on educational projects in South Lebanon, leading to a large number of schools being underutilized. The lack of coordination among them was due to their political differences. See \textit{An-Nahar}, December 8, 2004.

\textsuperscript{110} See \textit{Le Commerce du Levant} (December 2006, p. 22) for an overview of the report. Similarly, a review of the CS public investment concluded that out of the 366 schools built in the south, 78 should be abolished because they attracted fewer than 100 students. Nevertheless, the CS continued building schools, following the notion of balanced development. See \textit{An-Nahar}, December 8, 2004.
power in the Maronite presidency was deemed to be one of the causes of the civil war, as it subverted the principle of sectarian coexistence because it allowed Maronite domination of the political system. The reforms of the power-sharing agreement in the post-war period sought to remedy this defect of the system through a wider inclusion of sectarian groups and a spreading of political power among the three main presidencies. The second lesson relates to the foreign policy of Lebanon and the role of regional powers in maintaining peace and stability. An independent foreign policy was deemed to be a luxury that Lebanon could not afford, especially with respect to its regional neighbors. Post-war Lebanon became entirely dependent for its peace and stability on the goodwill of its neighbors, particularly Syria, and the regional consensus. The third lesson is that the laissez-faire ethos of the pre-war period was deemed to be unviable in a society divided according along sectarian lines. In the absence of a well-developed administration, catering for these socioeconomic inequalities took the form of corruption, lax fiscal policies, and institutional fragmentation.111

Power-sharing agreement

The post-war Lebanese power-sharing agreement responded to the defect of centralization with the defect of fragmentation. Due to its continuous dependence on sectarian representation, the ‘Ta’if Republic’ reproduced the initial conditions of fragmentation by institutionalizing sectarianism, and in some cases, solidifying it. This dependence on the goodwill of the various representatives of sectarian groups introduced a degree of rigidity in the official decision-making process, which was bypassed in practice through various means such as short-term agreements and bargaining, ad-hoc decisions and extra-institutional mechanisms. This combination of an official ‘rigidity’ with an unofficial ‘flexibility’ provided the system with a wider margin for accommodating conflict and dealing with regional change, at the cost of further de-institutionalizing the state and fragmenting it. By keeping conflicts at a low-intensity level, the Ta’if institutional framework managed to keep the centrifugal tendencies of the Lebanese polity in check but without reversing this tendency or establishing the procedure to transcend it.

One of the lessons of the Lebanese experience is that power-sharing agreements need to contain mechanisms to transcend their initial conditions of fragmentation rather than simply mitigating them or representing such societal fragmentation. In this respect, the Ta’if Agreement contained various mechanisms to initiate such a process. For instance, the agreement called for the establishment of a committee to abolish sectarianism, a clause that has yet to be implemented. More important, by dividing political power equally between Christians and Muslims, the parties to the Ta’if Agreement attempted to dissociate the question of demographic weight from the issue of political representation. Such a clause might have been the first step toward the de-politicization of demographic questions. However, those who formulated the agreement were not able to resist the pressures of a re-invigorated sectarianism, with more and more voices asking for the replacement of the 50-50 division of power with a tripartite division among Christians, Sunnis and Shiites, in practice re-inscribing political meaning into demographic weight.

111 The corruption and inefficiencies that plagued Lebanon in the post-war period could have been construed as the necessary short-term costs for peace building, if a developmental policy had been established to generate the required employment and increase in standards of living that could form the material basis of a sustainable peace. Nevertheless, the period of stability bought through corruption was squandered on misguided neo-liberal policies that greatly reduced the prospects of a sustainable and socially inclusive form of development.
Another lesson of the post-war period was the balance between the rigidity of the system and its flexibility. In a society haunted by mimetic tendencies, any change in the status quo is prone to be interpreted in sectarian terms, thus becoming a source of conflict. The quasi-religious adherence to the status quo emerges as the only viable solution. Yet, to deal with the changing environment, respond to unexpected developments, and have a modicum of institutional efficiency, flexibility had to be reintroduced into the system. The balance between rigidity and flexibility is a matter of each experience’s specific conditions, context, and the various developments to which it needs to respond. But as the Lebanese experience illustrates, introducing flexibility in an ad hoc manner leads to a wide disjunction between the realities of rule and the official codifications, leading to a de-legitimization of the latter and a possible descent into a chaotic institutional situation.

The State

Transcending the power-sharing agreement and managing the balance between flexibility and codification require an institution that is able to act as the agent undertaking these actions or as an arena managing them. The main, if not sole, candidate for this role is the state. Moreover, any power-sharing agreement, even if fully specified in the smallest details, will contain areas of uncertainty, illustrating the often tenuous balance of power sustaining it and the inability to predict all the contingencies that might arise. As such, power-sharing agreements will always require a certain degree of creative application. In addition, even if these agreements enjoy a high level of legitimacy, a certain deployment of coercion will always be needed to force all players to play by the rules. For both these roles, the state is again the natural candidate. But if there was any constant in the post-war Lebanese experience, it was the collective weakening of the Lebanese state: sectarian representation, institutional efficiency, and Syrian hegemony were all fulfilled through the fragmentation, weakening, and dislocation of the Lebanese state.

The inability of the state to play these roles was probably the main problem plaguing the Ta’if Republic. The absence of a normally functioning state that played by accepted rules of the game led to the subversion of the Ta’if Agreement and its transformation into a cover for sectarian bickering over state resources. The fragile peace instituted by this agreement became a source of blackmail rather than the cornerstone of a sustainable peace. Redistribution quickly turned into uncontrollable fiscal deficits and public debt. The always present and credible possibility of opting out of the agreement meant that the only limit to the blackmail of all political groups was the underlying sectarian balance of power and the deadly consequences of sectarian competition, if taken too far. As such, steps to refine the agreement, such as including mechanisms for transcending its initial conditions or managing the balance of flexibility and codification, are secondary issues compared to the central question of the institution in charge of applying the agreement and reforming it. In the absence of such an institution, even standard political processes present in all political systems, such as bargaining and negotiations, could have a crippling effect on the system. No amount of tinkering with the texts or devising mechanisms could bypass the question of the state.

This de-institutionalization did not plague all state institutions alike. For instance, the success of the monetary stabilization plan, at least according to its own goals, holds an institutional lesson that may inform other policies: the institutional autonomy of the Central Bank and its freedom from the usual corruption and inefficiencies of public institutions, its position in the Lebanese political economy, and the consensus around it are all factors that
contributed to the Central Bank’s survival and to its ability to carry out a stabilization plan against all odds. Yet, these factors cannot be replicated in all institutions because the conditions for an effective monetary institution might differ from the conditions of other institutions. The consensus created around the monetary institution and its perceived equidistance from all political players resulted from the fact that all parties had much to lose from a depreciation of the Lebanese currency and a weakening of the financial system, the losers of this conservative monetary and financial policy being too weak and dispersed to question it. The lesson that can be drawn from Lebanon’s case and used by other countries is the need to separate the issue of sectarian representation from the state or at least to draw boundaries between institutions of representation and institutions of execution. This requires shielding the state, or parts of it, from the clamors of sectarian representation and involves the introduction of alternative sources of legitimacy. A stagist approach should be adopted, one that recognizes that the available choices for policymakers are heavily dependent on their contexts. If a certain level of deference to sectarian demands is necessary in the early post-war period, the direction of the system should be aimed toward transforming legitimacy to a secular form of governance that will transcend sectarian divisions.112

Development and Peace-Building

Lebanese history brings into question the simple relations between economic variables and the probability of conflict. The economic dimensions of conflict and peace are complex and contingent on political factors. A weak economy or high levels of social inequality might be breeding grounds for the transformation of political conflict into violent conflict. Nevertheless, the various post-war episodes of relapse into violence in Lebanon were mostly political, having only a tenuous relation to socioeconomic factors. In other words, violence was not triggered by socioeconomic concerns, even if the relapse into violence was detrimental economically. But the absence of socioeconomic violence in the post-war period does not deny the claim that a stable and prosperous economy is a better environment for a sustainable peace. The Lebanese experience highlights the importance of a stable economic and financial environment to reduce the uncertainties that could breed political instability. Moreover, redistribution plays a crucial role in making the power-sharing agreement and subsequent peace credible and sustainable, especially if economic growth does not translate quickly into employment creation and an increase in the standard of living. Nevertheless, redistribution, especially when it is politically motivated and in the absence of a strong and coherent state, has economic and institutional costs. One of the pitfalls of the mix of fiscal and monetary policies is that even though they provided a mechanism to translate the Ta’if Agreement socially, the mix was not able to generate enough sustainable economic growth to foster higher standards of living and increased employment. Economic policy should contain a long-term dimension, the socioeconomic counterpart of the mechanisms for transcending the initial conditions of a power-sharing agreement, to avoid making redistribution a permanent

112 Nevertheless, the question of replacing the basis of legitimacy, currently grounded in a sectarian logic, by a new form of legitimacy based on secular grounds or on more modern forms of identity such as class, should be approached with great care for three reasons. The first is that such practices of social engineering often involve the deployment of violence. The second is that these modern identities often act as masks for sectarian logic. Part of the early political forces involved in the civil war conceived themselves along modern lines, but they were quickly transformed into tools for wider sectarian struggles. And third, the opposition between sectarian and modern/secular forms of identity needs to be reviewed, as this dichotomy has become more and more questioned in the literature.
fixture of the governance structure, with its ensuing economic and fiscal consequences. Another pitfall relates to the institutional framework for undertaking such redistribution. A politically motivated redistribution, in the absence of a strong state, can easily turn into an institutionalized form of corruption. Targeting sectarian inequality has led to a fragmentation of state institutions, paralyzing any sustained social policy and subsuming socioeconomic interventions to the shifting needs of sectarian inequalities. The main challenge, one that remains unresolved in Lebanon, is how to devise a plan for redistribution that is economically and institutionally viable and sustainable in the medium and long terms.

**External Enforcer**

Lebanon attempted to replace the state with an external enforcer that could fulfill its task and prepare the ground for a new form of Lebanese governance. Yet, this path was not successful, illustrating the ambiguities associated with foreign implementation of post-war agreements. Syria’s role was necessary as an external third-party player that could coerce the various factions into accepting the power-sharing system and the ensuing fragile peace. Yet, its intervention was not without costs. Syrian enforcers exacerbated the underlying conditions of instability, perpetuating the need for Syria to remain as external enforcer. Moreover, Syria rendered domestic peace and stability dependent on the regional edifice that was supporting the Ta’if Agreement, so that any change in the consensus would have immediate repercussions on the situation in Lebanon. It is hard to draw any lessons from this experience, especially as all the relevant variables are outside the scope of policymakers. Obviously, it is good to have a benevolent neighbor who is willing to spend time and energy to ensure that its weaker neighbor does not relapse into violence. And, of course, it is desirable to have a regional system that respects the sovereignty and integrity of the various states, limiting its interventions to official, accepted channels. And clearly, it would be a better scenario if the external enforcer acted to strengthen domestic institutions so that they could resume their rightful roles. In the absence of benign neighbors and a supportive regional system, the stability of the post-war country’s domestic peace will be a byproduct of regional stability. Peace building suffered when the regional consensus backed Syria in its role as an enforcer, as it suffered when the same regional consensus disintegrated. Similarly, peace building suffered when the external enforcer was one state, just as when it was replaced by a coalition of states with divergent interests. Any lessons at this level should be first and foremost political, acknowledging the logic of regional politics, the interests of the various players, and the limits such a regional system might impose on domestic development.

The difficulties of extrapolating lessons from the Lebanese case stem not only from the fact that it turned out to be a case of relative failure, with fragile political stability and an economy plagued by staggering debt. The difficulty is rooted in the fact that the two main variables in the Lebanese case turned out to be the regional environment and the question of how to establish a strong central state with the capacity to mediate among all political groups and enforce rules of the game. In the economic and political domains, a stagist strategy was adopted, which catered in the first stage to the requirements of sectarian representation and redistribution. The problem was the inability of the Lebanese system to move from this stage of short-term political stabilization to establishing the grounds for long-term peace and sustainable development. The inability to move to this second stage was rooted partly in the excesses of the stabilization plan and mostly in the inability to create a state and in the absence of a benevolent
regional enforcer. Maybe the only lesson that one can draw from the Lebanese case is that peace building is a deeply political question, involving violence, regional diplomacy, wars, winners and losers, and a certain political imagination. As Moore has observed about development and institution building, these processes are products “manufactured by politicians and state makers. And the production processes are rarely sweet smelling or harmonious, but noisy, nasty and, often cruel” (1993, 17). Maybe the lesson is to learn how to come to grips with these ‘noisy, nasty and often cruel’ processes.

**KEY ISSUES**

| Adopt a stagist approach, with each stages having different goals and requirements |
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| Governance | Include the relevant social players in the peace process and integrate the social groups that might be dependent on war activities in the state | Ensure a balance between political and social inclusion and the efficiency of the decision-making process, even if this might involve some inefficiencies | Set up mechanisms for transcending the initial conditions of conflict by enacting policies that might create or strengthen alternative political groups |
| Economic Policies | Launch a reconstruction project in addition to social policies that might alleviate the economic roots of conflict | ‘Tolerate a certain level of corruption and inefficiencies, conditional on the use of this ‘grace period’ for setting up the basis of a sustainable and socially inclusive development | Avoid neo-liberal policies that might create social costs that cannot be supported by a weak polity |
| External Enforcer | Initial need for an external enforcer that might alleviate the absence of strong institutions | ‘Tolerate a certain loss of sovereignty, conditional on the development of strong institutions | Gradually replace the external enforcer by domestic institutions |
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Mozambique Peace and Post Conflict Development: Managing Political and Macroeconomic Risks during the Transition

Calton Cadeado and Roberto Tibana

INTRODUCTION

Modern Mozambique has had two experiences of transition from war to peace. The first was during 1974-1975, marking the end of ten years of anti-colonial war led by the Front for Liberation of Mozambique (FRELIMO) against the Portuguese colonial regime. The transition process brought about the independent People’s Republic of Mozambique, a Socialist type regime led by FRELIMO. However soon after independence the Mozambique National Resistance (RENAMO), an insurgency movement, created and supported initially by the South Rhodesia minority regime and then by the South African Apartheid system, conducted a political, economic and military destabilization leading to a civil war that lasted sixteen years and was highly destructive. The second transition was during 1992-1994, marking the end of the civil war. This transition is widely considered successful because it was peaceful and brought about multiparty democracy after which five elections have been held regularly and, above all, the war did not re-erupt.

Although the two transitions were grounded in peace agreements, none of them stated explicitly the word power-sharing Moreover, in both cases, there were no governments of national unity and/or reconciliation. However, in this paper we show that in both transitions de facto power-sharing arrangements were put in place which were grounded in these peace agreements and were successful in attaining their specific objectives, namely to manage and reduce mistrust between the former belligerents, and overcome the potential resistance of either to move into a new political dispensation, and thus avoid the resumption of military confrontation

It is against this background that we address the theme of transition from war to peace and post-conflict development in Mozambique. On the first dimension, we focus on the role of power-sharing in the successful transition from war to peace. First, we discuss the nature of the power-sharing arrangement and then its contribution to prevent re-eruption of war. On the second dimension we describe the macroeconomic challenges faced by Mozambique at the onset of peace in 1992 and assess the policy responses taken to address them. In doing so we highlight the complexities arising from the combination of war-induced distortions on the one hand, and the inheritance of the socialist-type regime that prevailed in Mozambique prior and during the early stages of the conflict on the other, discuss the implications for post-war reconstruction and development of an orthodox stabilization initiated with the country still under the war. The role of aid flows is discussed as a cross-cutting issue across these two dimensions.

POWER-SHARING

Power-sharing is generally seen as a formula to ensure peaceful transition and reconciliation, especially in complex and multi-ethnic societies divided and devastated by war. However, this is a matter of great controversy amongst academics and political practitioners because power-sharing is also seen as perpetuating divisions in societies.
The debate about power-sharing in the context of divided societies is informed by two strands of theory (Jarstad, 2006: 3): conflict management theory and democratic theory. The conflict management approach, which includes writings of Donald Rothchild (1996), asserts that the function of power-sharing is to end war by including warring parties in the same government. In the democratic theory, in which Arend Lijphart (1968) represents the mainstream the function of power-sharing is to build democracy with great emphasis on democratic representation and elections as well as accommodation of different social and cultural cleavages. Despite the difference between conflict management theory and democratic theory, both approaches have in common the emphasis on the political sphere as the “most important” feature of power-sharing arrangements. Thus, power-sharing is seen as the sharing of positions in the government at national level and it is expressed in political agreements that define forms of joint or “inclusive” government. This is a narrow approach to power-sharing.

However, power is not restricted to the political sphere. It also encompasses non-political spheres such as economic, cultural and military power. Moreover, the existence of joint government is not an indispensable condition for power-sharing. Power-sharing can include any type of institutions dividing or sharing political, military, cultural, economic power at national, regional or local level (Jarstad, 2006:7) even without an expressive formal agreement. Thus, more than focus on joint government “power-sharing literature for the most part centers on the need to provide institutional guarantees and protections to ethnically fragmented, indeed, multinational states” (Barma, 2006:136) in order to provide long-term stability. This is the broad perspective of power-sharing that highlights the importance of inclusion (Akinyele, 2000) as well as the need to provide power to the powerless in all domains of social life. Above all, it reveals that power-sharing has to be functional, simultaneously, for peace and for democracy.

In the two Mozambican transitions, the power-sharing arrangements were not inclusive. In the first, many actors (considered by FRELIMO as anti-revolutionaries) were left out. The power-sharing involved only the Portuguese regime and FRELIMO, leading to the former handing over the power to the latter without election. Although apparently open and democratic in the sense of having culminated in elections, the inclusiveness of the second transition was limited by the dominance of the former belligerents (FRELIMO and RENAMO) in charting and managing the institutions of the transition. Notwithstanding the distinct historical contexts, the underlying common thread of continued search for nationhood and development that these two transitions aimed to facilitate makes it relevant to study both cases.

The end of the anti-colonial war: The Lusaka Accords and power-sharing

From 1964 to 1974, FRELIMO (a movement that resulted from the fusion in 1962 of various ethnic and regionally based anti-colonial groups) waged an anti-colonial war against Portuguese colonial regime whose roots go back to year 1468 (when the Vasco da Gama docked in Mozambique cost). The war resulted from the refusal by the Portuguese fascist regime to engage in a peaceful decolonization of Mozambique and its other African colonies, Angola, Cape Verde, Guinea Bissau and Saint Tome and Prince. In an international context dominated by Cold War and pressure for decolonization, FRELIMO anti-colonial war benefited from great support from socialist bloc as well as from liberal democratic and progressive groups from the West, including

113 On one hand this also means, to some extent, a restriction on the basic liberal democratic idea of majority rule. On the other hand, it can also mean commitment of the majority government to anti-exclusion and anti-restrictions in order to respect certain rights, mainly of the minority groups.
from Portugal. FRELIMO had also support from people and governments of Africa except the white minority regimes of South Africa and South Rhodesia, both allies of Portuguese fascist and colonial regime. Portugal had likewise support from Western capitalist bloc, allegedly, for its membership in the North Atlantic Treaty Organization (NATO).

As a result of the intensification of the anti-colonial wars and the related growing economic, social and political tensions within the Portuguese society a military coup took place in Portugal in April 1974. Its main motivation was to end the fascist regime and the colonial wars. The military junta thus introduced liberal democracy and the emerging new Portuguese administration actively engaged in negotiated solution to end the anti-colonial wars, including with FRELIMO in Mozambique.

After three “rounds” of negotiations, FRELIMO and the new Portuguese authorities signed the Lusaka Accords, on September 7, 1974. The economic and financial domains of Lusaka Accords remain secret. However, the key elements of the political and military accords are known. They determined the date of independence, as well as the conditions and mechanisms for the transfer of political and administrative power from the Portuguese authorities to FRELIMO. In particular they recognized FRELIMO as the sole and legitimate representative of the Mozambican people, and established mechanism for the joint supervision of civil administration and military structures during the period from the signing of the Lusaka Accords until the proclamation of independence, in June 25, 1975 (Lusaka Accords, 1974). With this outcome, FRELIMO succeeded in rejecting the other decolonization options and mechanisms of transfer of sovereignty such as referendum, elections or transitional administration led by United Nations.

FRELIMO and the Portuguese authorities created a government of transition and a Joint Military Commission composed of nine ministries led by a FRELIMO Prime Minister. Two thirds of the Cabinet positions were allocated to FRELIMO and one third to Portuguese representatives. They worked together and managed to transfer power from colonial regime to FRELIMO while Portugal assured the safety of its economic and financial interests, mainly the investments made in the construction of Cahora Bassa Dam. In the Joint Military Commission, Portuguese and FRELIMO representatives operated side by side to ensure the implementation of the cease-fire, to defend the territorial integrity of the country as well as the safety of Portuguese settlers.

Despite the leading position of FRELIMO, the decisions relating to both military and civil administration were taken by consensus. Although some unhappy Portuguese settlers violently opposed to the independence of Mozambique, they failed to prevent the transfer of power from the Portuguese administration to FRELIMO. On June 25 a new African state was peacefully born, ending nearly ten years of anti-colonial war.

The reasons for the successful transition based on this non-traditional power-sharing can be found in the strong political interest of both FRELIMO and the new Portuguese authorities. To entrench their legitimacy and control of power in their respective countries, both parties needed a quick process of decolonization to pave the way to devote their efforts to addressing pressing political, economic and social challenges in their societies. On the one side, the new Portuguese authorities were aware of the fragile post-military political situation in post-coup Portugal and were not interested in dispersing energies in lengthy decolonization risking lose power in Portugal. On the other side, despite its hegemony, FRELIMO was interested in controlling as soon as possible the political power and instruments of coercion in order to face potential domestic and external opposition. Therefore, none of the parties was interested in
risking their ascension and control of power by engaging in long and potentially turbulent confrontations over an inevitable decolonization.

The process leading to the eruption of the civil war

Soon after independence a war of destabilization against the new regime in Mozambique was initiated by the racist and minority regimes of South Rhodesia (today Zimbabwe) and Apartheid in South Africa (where some Portuguese colonialists, unhappy with the new regime in Mozambique, had taken refuge). The foreign policy of the then People’s Republic of Mozambique was openly anti-apartheid and in active support of the liberation movements in these two countries. The leadership affirmed repeatedly that Mozambique independence would be total and effective only when the people in its neighboring countries also had achieved their freedom as well. In this context, Mozambique provided, formally and openly, diplomatic, political and military support to Zimbabwe African National Unity (ZANU) and African National Congress (ANC) (Abrahamsson and Nilsson, 1994; Vines, 1996; Pavia, 2000).

Based on the Constitution of 1975 and its foreign policy, Mozambique implemented United Nations sanctions against South Rhodesia in 1976, closing the common border and, consequently, the access and the use of related infrastructures such as the oil pipeline, roads and railways leading to the sea. Additionally, Mozambique offered political asylum to combatants of ZANU and ANC as well as safe territory from where to operate. At a certain point this commitment to assist the regional liberation movements included sending troops to fight in the battle field in South Rhodesia. This “provocative” foreign policy terrified the two white minority regimes because it threatened their survival. And, to face the threat, the security services from Rhodesia, the Central Intelligence Organization (CIO), with alleged involvement of some former Portuguese settlers, invested financial and military as well as training and tactical guidance to create RENAMO to act “as eyes and ears for CIO in Mozambique” (Flower, 1987: xvii) and to launch military operations to weaken the FRELIMO government capacity to assist the Zimbabwean nationalist movements. Furthermore, Rhodesian troops engaged in direct military operations in Mozambique soil aiming at destroying ZANU basis, eliminating their military operatives and punishing FRELIMO’S government. This did not however prevent the end of the minority regime of South Rhodesia and the emergence of Zimbabwean black majority power, in 1980. As a result, RENAMO lost part of its external support but this did not mean its death or the end of the war in Mozambique. The Apartheid regime took over more active assistance to RENAMO which became part of the instruments of South African regional policy of destabilization against its neighbor countries, particularly Mozambique.114

The dominance of the external component in the creation of RENAMO has made it a complex matter to understand the internal dynamics of the civil war in Mozambique. On the one

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114 According to Geldenhuys, the first and most important aim of South African regional foreign policy was to force neighboring countries to prevent the ANC or South West African People’s Organization (SWAPO) establishing military or political facilities. The second objective reflecting the “total onslaught” was to make sure that, “Soviet bloc powers do not gain political and least of all a military foothold in Southern African States”. A further aim was to ensure that existing economic ties with the States in the region are maintained and indeed strengthened. This would ensure the political acquiescence of these states to Apartheid and prevent them from supporting moves to impose sanctions against South Africa. Finally, the Botha regime wished ensure that Southern African countries “moderate” their political criticism against Apartheid” (Cawthra, 1986:140/141). Finally, the [Apartheid regime led by] Botha wished ensure that Southern African countries “moderated” their political criticism of Apartheid” (Cawthra, 1986:140/141).
hand, while the exclusion of other political groups, their repression and suppression during the transition leading to FRELIMO hegemony created conditions of discontent and disenfranchisement that facilitated its quick spread and its own latter hold, the outbreak and conduct of the civil war in Mozambique was initially driven by external interests due to Mozambique “provocative” foreign policy. RENAMO’s denial of this proposition and their thesis that war was self-driven and for democracy does not stand the test of either the historical facts or RENAMO’s own record of undemocratic practices during and after the war. On the other hand, FRELIMO’s argument that the civil war was purely the result of external destabilization efforts also reflects its denial of responsibility for the ease with which the external confrontation with hostile regimes transformed into long-lasting civil war. Thus an objective assessment of the causes and dynamics of civil war in Mozambique requires careful examination of the contribution of the internal causes of the war that included FRELIMO anti-democratic policies and practices that violated human rights. These include well documented policies and practices such as prohibition of freedom of association and expression, nationalization of property, repression by the state police in order to ensure the affirmation of authority in urban and rural areas, marginalization of spiritual faith institutions and exclusion of local authorities, amongst other (Pavia, 2000: 25-29; Weinstein and Francisco, 2005: 161) FRELIMO’s own narrative is that these internal factors did not constitute the root causes of the civil war, squarely blaming not only its origin but also its perpetuation on anti-FRELIMO feelings created by the minority and racist regimes of South Rhodesia and apartheid South Africa. In this context FRELIMO’s government believed that the end of both minority and racist regimes would lead to the end of RENAMO and, also, the end of the civil war. This position became salient when South Africa increased the logistical support to RENAMO and, at the same time, conducted some direct military actions in Mozambican soil against ANC members.

**The road to the 1992 Rome peace agreements**

South Africa’s covert and sometimes no-so-covert operations against Mozambique created fears within the FRELIMO government that, given its clear military inferiority, it might not survive what it then perceived as an impending onslaught of the Apartheid war machine. To avert such an outcome, the FRELIMO government opted to engage in negotiations with the Apartheid regime aimed to build mutual assurances for regime survival. South Africa demanded that Mozambique stopped the support provided to ANC and Mozambique asked for the end of Apartheid support to RENAMO. The negotiations culminated in the signing of the Accord of Good Neighborhood and Non-Aggression in March 1984, also known as Accord of Nkomati. For Mozambique, Nkomati primarily aimed to prevent South Africa direct military attacks in its soil and safeguard its independence and sovereignty (Veloso, 2006:176) as well as to eliminate the support to RENAMO. However, after the signing of the Accord of Nkomati, the war intensified in both countries. The ANC found alternative supply routes and internal strategies to intensify the anti-apartheid struggle, and RENAMO did not disintegrate and the war also

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115 The Accord of Nkomati forced South Africa and Mozambique to prevent the use of their territories as bases for political violence against each country. In this context, some ANC members were forced to move from Mozambique to other countries, for instance Zambia and Tanzania. Thus, the Accord of Nkomati was seen by some African governments, some African leaders and even some ANC members as treason of Mozambique to the struggle against the Apartheid regime. But for some other ANC leaders quoted by Veloso (2006:178), the Accord of Nkomati had a strategic objective of ensuring the survival of FRELIMO in power to guarantee continuing support for the ANC.
intensified in Mozambique. Moreover, RENAMO extended the war for all over the country causing thousands of deaths and destruction of social and economic fabric of the country (Abrahamsson and Nilsson, 1994:176).

As a result of the escalation of the war, the balance of force between FRELIMO government and RENAMO changed drastically militarily and politically. Militarily, the situation was much more in favor of RENAMO due to its guerrilla strategy. RENAMO controlled vast portions of the country and its war activities reached the inner periphery of all provincial capitals as well as the country’s capital, Maputo. According to Rodrigues (2006:27), RENAMO was much strong on the battle field militarily than the FRELIMO government troops, to the point that in 1986 the insurgency took control of 13 out of 18 districts in the most populous province of Zambézia. This situation created fear in the military and intelligence circles in Maputo that RENAMO would march into Quelimane, the capital of Zambézia, and split the country into two parts. With this scenario, RENAMO affirmed its agency in the war and became an undeniable party that could no longer be ignored. This military strength of RENAMO made the military solution to the war wished by FRELIMO impossible and forced the FRELIMO government to go to the negotiation table.

However, the diplomatic battlefield was much more favorable to the FRELIMO government than RENAMO (Rodrigues, 2006:27). An instrumental role in this area was played by the Gersony Report (commissioned by US State Department) which documented the atrocities attributed to RENAMO and that contributed to demonize the insurgency. Thus, by the end of the 1980s, RENAMO had become diplomatically more fragile and its military strength was threatened as the alliance with Apartheid regime weakened. This was due in part to the intensification of the international condemnation and sanctions against the white minority regime. As a result, RENAMO suffered substantial reductions of financial and logistical support (Abrahamsson and Nilsson, 1994, Hume, 1994; Vines, 1996). Conversely, FRELIMO government saw its legitimacy increase internationally through its openness to the West, and mainly toward the conservative governments of Margaret Thatcher and Ronald Reagan. For instance, President Samora Machel won the British Government’s sympathy as reward for assisting in the diplomatic efforts to end the colonialist British position in Southern Rhodesia leading to the emergence of Zimbabwe in 1980. In 1985, Machel made an official working visit to the USA where he met President Ronald Reagan. In this environment of international openness, Mozambique obtained membership to the Bretton Woods institutions in 1985 and in 1986 the government started to implement a structural adjustment program that marked the reinstatement of a market economy. Internally, FRELIMO propaganda machine depicted RENAMO as ‘armed bandits’ and used the violent acts attributed to the insurgency to demonize their war and render their democratic calls and claims illegitimate. Additionally, in 1990, with the war at its highest intensity and partly in preparation for direct peace negotiations, the single party People’s Assembly of Mozambique approved a new constitution that formally eliminated the proclamation of a socialist economic system and introduced multiparty democracy while the war was in progress. These political developments further undermined RENAMO’s arguments of war for democracy.

RENAMO controlled people in some parts of the country, mainly in the villages, rural areas while the government dominated in the urban areas. According to Vines (1996: 75), RENAMO claimed control of 80-85 percent of the country and described the territory under its control as “liberated zone”. This may be exaggerated and was denied by the government. However, the government did not present its counter arguments and evidence.
An equally significant internal factor leading to the Rome Peace negotiations and agreements was the drought that affected substantial portions of the country in 1990-1991, further exhausting the resources extracted by both sides to sustain the war. Internationally, the end of the Cold war and collapse of the Apartheid regime contributed to the final collapse of the extensive support that both FRELIMO government and RENAMO received from their external allies. Finally, the looming global economic recession of the early 1990’s meant that even the newly won sympathy of the Western world was not sufficient to assure FRELIMO government of continued increase in western aid money, let alone to use it to sustain an unwinnable war.

Overall, the internal and external circumstances narrated above concurred to force both belligerents to the negotiation table now in the public arena of Rome, Italy, rather than through secret emissaries mixed with public denials, ambiguous disclosures and mutual recriminations as had been the case in previous years. It seems that in late the 1980s and early 1990s, both FRELIMO government and RENAMO “reached exhaustion” of resources as the supporters from Cold War period vanished and the regional situation changed with the fall of the Apartheid regime. Domestically, people demonstrated a general tiredness of war and massive desertions occurred from both military forces, all signaling a sense of lack of legitimacy from both parties to continue the war” (Lala, 2001: 62). Overall, both belligerents appeared to realize that they reached the “hurting stalemate” and the solution for the war should be political, not military.

Once in Rome, however, the belligerents took two years to negotiate the end of the war and post-conflict arrangements. Power-sharing interested neither RENAMO nor the FRELIMO government because both parties were confident of their victory in the first multiparty elections, which was seen as a crucial step in the transition process. The conviction of RENAMO was based on its dominance of and support from rural areas against the predominance of FRELIMO in the urban areas. RENAMO believed that the majority of voters were in rural areas under its control, and that they would punish FRELIMO government for its Socialist policies and anti-popular practices. Conversely, FRELIMO’s confidence on its victory was based on the presumption of the existence of high anti-RENAMO feeling in the society, due to the atrocities, massacres and terror that were attributed to RENAMO and explored by the FRELIMO propaganda machine.

The reluctance of both RENAMO and FRELIMO government to accept the idea of power-sharing created fears in the national and international policy-making circles as well as public opinion, that the Rome peace process could fail, and that Angola’s 1991-1992 scenario of failed peace arrangements would be repeated in Mozambique. The parties resisted the international pressure to the point that the General Peace Agreement (GPA) was signed in October 1992 without contemplating any power-sharing arrangement in the form of a government of national unity and reconciliation. This was not the first time this sort of power-sharing arrangements was rejected in Mozambique. FRELIMO had in the past rejected suggestions from Apartheid South Africa mediation for a multiparty system with an initial government of national reconciliation and power-sharing with RENAMO (Vines, 1996: 21-22).

According to Mario (2004: 83-84),

Manuel Bulhosa (considered by Mozambique and South Africa counter-intelligence sources as one of the most important financial supporter of RENAMO) proposed negotiations for peace in which he suggested a transformation of Mozambique from unitary to federal state with large regional autonomies and power-sharing between FRELIMO government and RENAMO founded in local bases. According to this
hypothesis, at the time completely rejected, even by Portuguese liberal sectors, the districts and provinces would have been divided in accordance to the predominance of people of RENAMO and FRELIMO government.117

The GPA and its non-traditional power-sharing arrangements

The critical period of transition from civil war to peace runs from October 1992 (the signing of the Rome GPA) to October 1994 (when the first multi-party elections were held).

The GPA is composed of seven protocols focused on political guaranties of mutual respect as well as commitment to reach peace and maintain cease-fire; criteria for creation and recognition of political parties; definition of principles of electoral law; military issues; cease-fire and donor conference (GPA, 1992). The GPA envisaged a post-conflict political system based on Westminster-style liberal democracy in which “the winner takes all” and is guaranteed “full power” to set the future direction of country as well as ensure the prevalence of peace.

The electoral process was guided by the electoral law approved in December 1993, which reaffirmed the commitment of the former belligerents to the principle of “winner takes all.” This principle formally reinforced the reluctance of both FRELIMO and RENAMO to share political power due to their conviction of victory in elections. Despite this divergence, the FRELIMO government and RENAMO shared power at the level of specialized technical organizations, namely the National Electoral Commission (CNE), and the Technical Secretariat of Electoral Administration (STAE). They also shared power in the Mozambican Defense Forces (FADM). A provision of the GPA allowed RENAMO to have under its control armed men beyond the control of the state apparatus. This arrangement was part of the security assurances required by RENAMO, given its mistrust in the ability of the government security forces to ensure the security and safety of its leadership. These arrangements are what we consider non-traditional forms of power-sharing because they transferred the political battlefield from where it belonged such as Cabinet and Parliament, to what should have been mainly technical and non-political and non-partisan organizations. They had the merit of expediting the signing of the peace agreement and contributed to ensuring certain mutual control over the transition process, diminish or at least manage mistrust and build confidence between the former belligerents. However, they established a precedent which has since been allowed to remain intact and which has had the negative long-term consequences of depriving Mozambique of genuinely independent and non-partisan institutions of electoral administration and neutral civil security and military organizations.

The following paragraphs look in some detail at the architecture and functioning of these elements of non-traditional power-sharing, assess how they achieved their specific objectives and discuss some of the limitations they brought to the current political situation in Mozambique as well as how all this bodes for the maintenance of a lasting peace in the country.

117 The idea of a federal state was also proposed by some Mozambican political parties after the end of the war, but faced rigid opposition by those who defend the unitary state philosophy. According to Brito and Weimer (1993: 15), those who defend the unitary state consider the federal state an unrealistic proposal due to the dangers in poses to national unity by creating internal conflict and even separatist tendencies. However, they recognized that an effort should have been made to respect the ethnic and cultural differences of the country by accepting that some provincial governors could be elected by local population, without the need to create a federal state. By contrast, those who defend federalism (fundamentally, each current Province would become a state) underlined that this tendency resulted precisely from the centralized and discriminatory action of FRELIMO and that federalism would be the best way to dignify and save the different cultures and traditions of the country.
Power-sharing in the National Electoral Commission

The National Electoral Commission (CNE) was created under the auspices of the GPA for the management and organization of the electoral process. This commission should, in principle, be a technical apolitical institution created by the government. However, according to the GPA the creation and composition of the CNE became political, with its membership determined according to partisan shares agree between the former military belligerents. Thus, the CNE was composed of 21 members, 10 from FRELIMO, seven from RENAMO, three from “non-armed parties,” and one from civil society.

The CNE was organized according to the administrative divisions of Mozambique. Thus, electoral commissions were based at the provincial and district levels. At provincial level, the FRELIMO government had the right to appoint three members, one of them as a president. RENAMO had the right to appoint two members, one of them as a deputy president and the parties registered when the electoral law came into force also had the right to jointly appoint one member. The same principle applied at the district level, where the presidency was headed by members appointed by the FRELIMO government and the vice presidency by members of RENAMO (CNE, 1995: 18).

The “power-sharing at CNE” became crucial to the continued confidence/trust-building process initiated during the peace negotiations. By establishing joint control of the electoral process, it allowed the negotiation and resolution of matters of concern to the main political actors and former belligerents before they could escalate out of control. It was thus instrumental in preventing the resumption of war. This was probably the guiding concern at the core of the intentions and actions of the political and non-political actors when designing and agreeing on the electoral institutions.

However, the composition of the CNE made the political process bipolar and allowed it to be monopolized by FRELIMO and RENAMO. This is one of the arguments used by “non-armed political parties” to consider the Mozambican political process as not inclusive (Brito and Weimer, 1993: 15). Furthermore, some technical discussions during the preparation of the elections assumed partisan political connotations and sometimes made CNE a forum of continuation of political disputes, mainly between the former belligerents. This was responsible for some political tensions and exposed the politicization and lack of independence of the electoral institutions. Although this has prompted partial revisions of the electoral law, the fundamental flaw which is the politicization and lack of independence of this key organ of electoral administration remains to date.

Power-sharing in the Technical Secretariat for Electoral Administration

The technical Secretariat for Electoral Administration (STAE) was to be primarily, as its name suggests, a technical and executive organization. However, it was also formally shaped according to political lines and reflected the dominance of FRELIMO and RENAMO. Thus, at the central level, STAE integrated initially 50 members. 25 proposed by the FRELIMO government, 13 from RENAMO and 12 appointed by the UN (CNE, 1995: 18). The integration of UN members was meant not only to allow the effective deployment of the logistical means necessary to assist the administration of the first multi-party elections after the war. It was also,
to some extent, to assuage RENAMO fears that FRELIMO dominance would undermine the effective participation of its members in key administrative decisions.

Like the CNE, the STAE was established at district, provincial and/or central levels. The presidency of STAE was legally attributed to the members proposed by FRELIMO and the vice presidency to the members appointed by RENAMO. In this context, the STAE was also polarized between FRELIMO and RENAMO, dominated by the former in all regions of the country. As a result the administration of the electoral process, instead of being purely technical and independent, became subject of systematic political interference and manipulation.

The relationship between former belligerents was marked by such mistrust that it became a major obstacle to the transparency, efficacy and efficiency of STAE and, above all, to the “pacification and democratization of the country.” In this context, STAE’s actions and performance in the conduct of electoral processes created tensions that made the “ghost” of war always present in the euphoric atmosphere of peace and reconciliation. This tension was evident in the first day of voting for the first multiparty elections, when the leader of RENAMO announced that he would not participate in the elections. The tension was also evident in subsequent elections due to accusations of fraud. At the height of these tensions, there have even been losses of life such as in Montepuez in 1999 and in Mocimboa da Praia, in 2005, when the government used heavy-handed means (with resort to paramilitary forces constituted after the first elections and outside the trust and confidence building spirit of joint FRELIMO-RENAMO composition) to exact repression on RENAMO sympathizers in peaceful protests against perceived electoral fraud.

These events were later used to draw lessons pointing to the need to depoliticize technical electoral institutions and increasing their independence, professionalism and participation of the civil society. Some of these lessons were taken and reflected in the subsequent revisions of the electoral law. However, the fundamental flaw which is the politicization and lack of independence of the key organs of electoral administration remains a major concern of the Mozambique post conflict political dispensation.

Power-sharing in the Mozambican Defense forces

The General Peace Agreement defined the principles and procedures for the constitution of the Mozambican Defense Forces (FADM). The composition of the FADM aimed at ensuring trust between the former belligerents during the period between the cease fire and the establishment of a new democratically elected government (Lala, 2001: 64). In this context, the FADM were to be composed “50%-50%” by soldiers drawn from the FRELIMO-led government forces and from RENAMO’s military forces, with a high command made up of two officers of same rank designated by the Government and RENAMO. The “joint command” was applied extensively across to the various units of the army in different regions of the country. By an agreed principle, in units of the FADM where the top command was given to one side, the deputy position was given to the other side. Thus, the first Chef of staff of the FADM came from FRELIMO government forces while his deputy came from RENAMO forces. In the navy, the commander was from RENAMO forces and his deputy came from the FRELIMO government forces. In the air force, the commander was from FRELIMO government forces and the deputy came from RENAMO forces.

The fundamental objective of the “joint command” was to build confidence between former belligerents and to facilitate the management of potential instabilities that could
jeopardize the implementation of the cease fire. This did indeed prove effective in dealing with some disturbances and disobedience that occurred during the process of disarmament and demobilization.

According to what is publicly known of the GPA the joint command was defined for the transitional period (1992 – 1994). Past that period, there have been claims from the RENAMO political leadership and the independent media that some reforms involving retirement of officers have been driven by political interference by FRELIMO, aimed at eliminating the presence of RENAMO members in the armed forces. However, the spirit of power-sharing prevails with regard to the nomination of the Chef of Staff and its deputy as well as some regional commanders.

RENAMO armed men

The war in Mozambique ended with a *suis generis* agreement, which ran against the Constitution but did not prompt its amendment. It allowed RENAMO, supposedly a political party, to have an armed forces under its command, allegedly for the purpose of the protection of its top leadership\(^{118}\). Lopes-Pintor considered this situation an incomplete demobilization and disarmament and a potential threat to the process of democratization, reconciliation and peace. In his analysis, the resumption of war was prevented only because of strong pressure from the international community (Lopes-Pintor, 1997:45). Although the results of the multiparty elections were always rejected by RENAMO and its leader who threatened to return to war relying on its armed men, they never took concrete action in this regard. Furthermore, despite his frequent threats to “set the country on fire,” RENAMO’s leader also systematically contradicted himself by reiterating that he was the “father of the Mozambique democracy” and that he was fully committed to maintaining the peace.

RENAMO’s claim to have under its command armed men partly reveals its lack of trust in the state security apparatus dominated by FRELIMO to guarantee the security of its leader. It also reveals RENAMO’s fear of total loss of power to pressure and to influence FRELIMO’s actions. On the other hand, to allow the existence of a “parallel army” can be interpreted as attempt by the government to make concessions in order to build confidence and achieve peace. But it also means that the state has partially abdicated of its monopoly over the instruments of coercion in order to maintain peace.

Although this arrangement should have prevailed only until the end of the transitional period, RENAMO has maintained armed men to date. Their number and exact location is unknown, except for the contingent located in Maringue and Inhaminga, in Sofala province, where RENAMO had its headquarter during the war. On the surface, the maintenance of these armed men by RENAMO has not deterred the FRELIMO dominated administration from repeatedly rigging the elections and handing consecutive and increasing parliamentary majorities to FRELIMO. Soon after the signing of the GPA, RENAMO armed men represented a real counter-balance to the FRELIMO government. However, with time, they do not seem to constitute a real source of power to counter-balance the hegemony of FRELIMO and, apparently, do not seem to represent a real threat to the prevalence of peace. At most, their presence appears

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\(^{118}\) The issue of armed men has created fears of resumption of war during the transition period. This fear has from time to time been heightened, when people and the media report the discovery of hideouts containing arms that belong to both former belligerents.
to have served well FRELIMO’s purpose of branding RENAMO as a war-bent organization that represents a threat to peace and stability, as it has done during all the electoral campaigns.

The significance and impact of informal or non-traditional power-sharing in Mozambique’s peace process and democracy

Power sharing in the CNE and STAE ensured some degree of transparency to the electoral process that culminated in the peaceful first multiparty elections with “87% of participation” (CNE, 1995:72) despite the tension and low trust between the former belligerents. Moreover, the joint leaderships of CNE and STAE served to reduce the total control by FRELIMO over political processes of transition, which should have ended with first multiparty Presidential and Parliamentary elections.

As an outcome of the first elections, Joaquim Chissano, for FRELIMO, was elected President with 53.3 percent of votes and Afonso Dhakama, for RENAMO, was the runner-up with percent. In the new Parliament, FRELIMO gained 129 seats, RENAMO 112 seats and Democratic Union (UD) 9 seats (CNE, 1995) of a total of 250 seats. These results gave to RENAMO and its leader Afonso Dhakama the status of leader of opposition. Above all, in the eyes of the electorate, it revealed some degree of balance of power between FRELIMO and RENAMO. This balance of power matched the fact that up to the end of war, RENAMO controlled vast portions of the territory. As a result, in some of these areas, the first administrators or counselors of the new government after the first multiparty elections came from RENAMO, breaking the agreed principle of “winner takes it all”. However, in this case, the RENAMO officials were later integrated into the state apparatus and they became professional civil servants. To some extent, this solution reduced RENAMO’s political effectiveness locally, a fact that may partly explain the dramatic declines in its share of the vote in subsequent elections.

At the central level, despite the presence of UD members, the parliament was dominated by the FRELIMO and RENAMO dichotomy. This polarized situation prevailed beyond the first parliament with a slight difference, as small parties entered the parliament through coalition with RENAMO (RENAMO-União Eleitoral). However this coalition was not powerful and solid enough to challenge FRELIMO’s hegemony and has since disintegrated. This disintegration also marked a turning point in RENAMO’s political fortunes as the same factors that lead to it also played out internally in the organization, resulting in successive purges and desertions of its senior members. This ultimately lead to discord which resulted in a new political party, the Movimento Democrático de Moçambique (MDM).

In the defense and security sphere, power-sharing was limited by the GPA to defense. RENAMO was never allowed to enter the State intelligence services (Serviço de Informação e Segurança do Estado – SISE, dominated by FRELIMO as it was its predecessor SNASP – Serviço Nacional de Segurança Popular, created during the times of the single party state). Meanwhile, some of its law rank military who were demobilized were integrated in the Ministry of Interior, but this arrangement has never reached the top ranks. This way, while sharing some power in the military, FRELIMO has kept the leadership and control of the critical security sector. It is not been clear why RENAMO allowed such situation to occur which has apparently contributed to its own undoing as potential effective political force.

POST-CIVIL WAR ECONOMICS AND STYLIZED FACTS
Key elements of the economics of civil war and transition to peace

The seminal work on the economics of war and post-civil-war reconstruction in the African context is by Collier and Gunning (1995). Their focus is on the way transition from war to peace affects private portfolio choices and the implications of these shifts for government policy. They start by noting private agents’ unusually high preference for liquid assets during war time, and the unusually high uncertainty that characterizes the transition to peace as well as the poignancy of the combination of these factors at the onset of peace. They then explore the opportunities opened by private agents’ potential desire to adjust portfolio holdings when peace arrives, as well as the constraints imposed by their likely unwillingness to hold government liabilities at reasonable interest rates. The overall macroeconomic policy prescriptions that they advocate include a) monetary policy targeted at price level rather than any monetary aggregate (given the inherent shifts in money demand due to various conflating factors including fiscal volatility and the unpredictability of the inflationary consequences of the fiscal deficit at any level); b) the sale of government assets such as housing, land, and state owned enterprises as a substitute for government borrowing; and c) a subsidy on fixed investment through a policy of undervaluing the exchange rate.\textsuperscript{119} Collier (1999) builds on a further analysis of economic consequences of civil war. He notes that a typical impact of civil war is that institutions for contract enforcement break down and social order collapses. In response, economic agents disengage from transactions-related activities (e.g. transport and trade) and asset-providing activities (transport, financial services), as well as from economic activities that are intensive in assets and/or transactions, like most exports. The result is a major growth deceleration and outright growth collapse which affects disproportionately affects the exporting capacity of the conflict country. Elbadawi and Schmidt-Hebbel (2008) emphasize the shrinking demand for domestic money as an asset that facilitates transactions and stores value.

Pulling together these contributions, Elbadawi and Soto (2010) summarize the post-war economic agenda by emphasizing three central macroeconomic policy objectives for countries emerging from this type of conflict, namely: a) restoring aggregate growth; b) restoring export growth; and c) restoring money demand. They note that none of these objectives can be effectively and efficiently achieved independently. For instance, restoring growth in post-conflict requires a vigorous recovery by the export sector and an adequate re-monetization process. Thus achieving all objectives effectively requires well designed, sequenced, and coordinated fiscal, monetary and exchange rate policies. Further, achieving all these objectives also requires external aid that is also well sequenced and coordinated within a coherent macroeconomic framework (as for instance in Buffie et all (2004) and Adam et all (2008)).

The importance of aid in post-civil war reconstruction is discussed frequently in the literature. It goes beyond its critical role in financing physical rebuilding. For instance Adam, Collier and Davies (2008) highlight its role in monetary reconstruction. This is because governments fighting civil wars need to finance higher military expenditure with limited borrowing options, with the result that the equilibrium rate of inflation that the government is willing to tolerate for a given level of seigniorage will be much higher during the civil war than under normal peaceful conditions. Yet the post-war administrations also need to expand budgets

\textsuperscript{119} Other recent evidence from the growth literature suggesting that real exchange rate undervaluation can promote growth include Aghion et al (2006), Aguirre and Calderon, (2006); Elbadawi et al (2007); Rodrik (2008), and Williamson (1997). Concepts and methods of calculating seigniorage are as explained in Buiter (2007).
to meet reconstruction needs. Thus high levels of war-time monetization of the deficit are likely to also continue in the post-war period, since post-civil war governments experience the same borrowing constraints facing war time governments. This implies that post-civil war inflation will remain high. Combined with the slow recovery in the demand for money in the aftermath of civil war, this creates a tighter tradeoff between seigniorage and inflation. Aid can help reestablish the pre-conflict equilibrium level of inflation by facilitating monetary reconstruction through relaxing government financing constraints and thus removing the need to monetize the deficit, which leads to crowding out private agent demand for money.

However, the literature also notes that because different exchange rate regimes allow for different degrees of independence of monetary policy, protection against real shocks, and macroeconomic stabilization, the effectiveness of aid to finance post-conflict monetary reconstruction may depend in a substantial manner on the choice of the exchange regime. This issue is one of the main topics explored by the econometric work of in Elbadawi and Soto (2010: 36) who conclude that

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\text{[A]id was found to help restore the post-conflict demand for broad money (M2) under all three [broad exchange rate] regimes [considered in the investigation, namely fixed, managed floating, and free floating], while it would help promote the demand for narrow money (M1) only under the managed and floating regime. Instead aid was found to have deleterious effects on the M1 demand for the case of fixed regime.}
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**Mozambique stylized facts**

We now turn to a summary of the stylized facts of Mozambique’s economic developments during civil war and at the onset of peace, focusing on an informal assessment of how they tally with the insights from the literature reviewed in the previous paragraphs.

**Output and export growth collapse**

The damage to Mozambique’s economy brought about by the civil war came on top of the damage caused by the military confrontations with the hostile white minority regimes of South Africa and Southern Rhodesia (see Tibana(1998)). This was compounded by a socialist-type regime that restricted free markets and distorted agents’ behavior (see Tibana 1994).

Towards the mid-1980s signs became clear that the government had failed to engender a growth “take-off” through a socialist-type “big-push” investment, while sustaining a military confrontation with Apartheid South Africa and former Southern Rhodesia. The combined result of these factors was an unprecedented collapse in economic growth.

Recovery seemed to take hold in 1980, stimulated by an investment blip as the government tried a ‘big-push’ with large scale projects, but even then GDP was only 80 percent of its 1975 level and the recovery did not last. By 1986 real GDP was below 60 percent its level in 1980.
This collapse in total output was led by exports. In the two years of 1976 and 1977, current export earnings in US Dollar terms fell by around 31 percent and 25 percent respectively, despite increases in commodity export prices that generated substantial gains in terms of trade. The second half of the 1980s was also characterized by major losses in export earnings (Tibana, 1994: 4). Cargo transport is one of those activities that most felt the impact of war. Domestic cargo transport, which had most suffered from the decolonization exodus as tonnage hauled fell by 16.6 percent in 1974 and 15.7 percent in 1975, declined further due to the combined impact of civil war. By 1984, it was only 56.6 percent of its 1975 level (Tibana, 1998: 145). Inflation in Mozambique, which had been double digit and highly volatile since independence in 1975 and stood at around 10 percent between 1975 and 1980, eventually increased to between 45 and 50 percent by 1985.

Orthodox ‘shock therapy’ in a war environment (1987-1992)

With limited assistance from the former “socialist allies” (Soviet Union and Eastern Europe), Mozambique turned to the West for assistance with both ending the escalating military confrontation with Apartheid South Africa and stemming the collapse of the economy. To provide this assistance in the context of the Cold War, the West needed assurance of Mozambique’s disengagement from the Communist block and the abandonment of its socialist experiment. In response, while on the military and diplomatic fronts the government moved to sign the Nkomati Peace Agreement with the Apartheid regime, the authorities were encouraged to embark on partial market liberalization with the IMF and the World Bank as tutors. Both these measures were taken in early 1984 and resulted in short-lived economic recovery, as the civil war continued and constrained the response of the economy to partial liberalization measures and the limited injection of foreign money.

Faced with the failure of the partial market liberalizations of 1984 to yield long-lasting recovery and growth of the economy, and with war continuing, the authorities embarked on an orthodox stabilization and structural adjustment program in 1987, with massive currency devaluation and tight fiscal and monetary policies. The exchange rate was devalued by 615
percent between January and December 1987. This was followed by more devaluation under a crawling peg regime with the US Dollar (1989-1992) and combined with additional domestic price decontrols. Money supply was dramatically cut back by a whopping 130 percent (as inflation was 175 percent, following shock nominal devaluation at the start of the program, and nominal M1 increased by only 60 percent). Between 1988 and 1989, nominal M1 increased by an average of 50 percent, meaning no growth in real money supplied to the economy as inflation was still double digit at around 45 percent per year. Nonetheless, monetary policy became lax in 1993, the first year after the end of military hostilities, as the issuance of coins increased by 82 percent compared to the previous year. This was nearly double the rate of inflation and around 30 percentage points above the previous year’s rate of inflation. Furthermore, net credit to government increased substantially, following two years in which the authorities made substantial debt servicing reducing government liabilities with the banking system. Privatization was undertaken more gradually and selectively at the start, commencing with sales of the urban housing stock and small scale commercial establishments that had been nationalized soon after independence and moving to medium and large scale agricultural and industrial enterprises later in the 1990s.

The significance of these macroeconomic developments is that there was a big monetary and fiscal shock at the onset of peace in 1992. These shocks triggered some uncertainty about the ability of the FRELIMO-government to sustain a well-coordinated set of stabilization and structural adjustment policies in times of military and political transition to peace. This uncertainty was further compounded by the delay in the deployment of UN peacekeeping forces (ONUMOZ) and the initiation of the demobilization and disarmament process that was to follow the signing of the GPA in October 1992. These delays created an uncertainty whether the military cease-fire was going to hold.

Demand for money

Demand for money appears to have shrunk substantially during the war (Figure 2). After a slight resumption in 1989-1993, % M2/GDP declined sharply from 25 percent in 1992-93 to 17 percent in 1996. Although it recovered afterwards, it took almost ten years for demand for money to reach its 1992-93 level, a remarkably slow pace of monetary reconstruction. Part of this is related to the way aid responded (or not) to the reconstruction needs at the onset of peace. This is discussed further below in this paper.
Aid, monetary reconstruction and seigniorage

Aid to Mozambique increased substantially in the years leading up to the end of the civil war in October 1992. However, it declined steadily in the four years soon after the peace agreement between 1993-1997, stagnated for another four years between 1998-2001, only resuming strongly in 2002 (Figure 3).

This aid disengagement at the onset of peace and the years after was partly the reason why monetary reconstruction was delayed. The consequences were devastating to the economy. As aid declined and growth faltered money demand continued to erode (1992-1995). As government made efforts to spend on reconstruction and maintenance of peace (including to appease disgruntled electoral losers), it did so in an apparently highly inefficient way as it settled
for higher inflation (Figure 4) for too little seigniorage (initial portions of Figure 5). It was only in the early 2000s, when aid resumed and kept steady, that growth also resumed facilitating the reconstruction of money demand and thus allowing the authorities to extract higher seigniorage at very low and stable rates of inflation.

In the following paragraphs we summarize selected issues of Mozambique’s post-civil war macroeconomic management.

**Fiscal risks and policies**

*Conventional fiscal adjustment and hidden risks*
During the 1990s and early 2000s, the authorities in Mozambique made strides towards macroeconomic stabilization despite the pressures of the transition from war to peace. However, there were simmering problems related to the quality (sustainability and efficiency) of fiscal adjustment as substantial fiscal risks remained unaddressed. Assessments focused on conventional fiscal measures ignored the fact that governments can reduce their measured deficit without carrying out any “true” adjustment (Polackova, 1998). Indeed, faced with outside (namely IMF) pressure and close monitoring to reduce its conventional deficit, a government can respond by increasing hidden or off-budget liabilities, thus compromising the efficiency and sustainability of fiscal adjustment. Intra-year debt issuance and buy-back operations can also conceal the scale of fiscal profligacy (even though these can in some cases show up in the resulting flow of interest payment). Therefore, a sequence of years of balanced budget or low conventional deficit and public debt does not necessarily mean that fiscal policy has been prudent or that the fiscal outlook of the country is good.

Figure 6 illustrates some of these issues. After a string of ten years of near-balance (1991-1994) and surplus (1995-1998), Mozambique’s primary budget balance suddenly deteriorated into deficits (1999-2001). Further, events in the last two years of the period under consideration (2002-2003) reveal substantial and increasing fiscal instability with the budget balance swinging frequent and increasingly widely between deficit and surplus within a short period of time.

The deficit after interests payments became even wider and more volatile, mirroring the explosive behavior of interest payments (Figure 7). These doubled from below 5 percent of total current expenditure in 2001 to nearly 10 percent in subsequent years, with domestic interest payments being 75 percent of total interest expenditure. These budget outcomes revealed two

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122 When they are not systematically profiled and monitored contingent liabilities become a “surprise on realization”, and there will be a tendency for them to be dealt with off-budget. There is therefore a close relationship between the prevalence of certain types of contingent liabilities and off-budget transactions, and both appear to have been endemic in Mozambique in the 1990s and early 2000s.
serious hidden fragilities of the fiscal situation. One was the tendency for the primary budget surpluses (i.e. the balance before accounting for interest payments expenditure) to be absorbed by interest payments. The other was the close association between the explosive volatilities of the budget deficit and of interest payments since 2001.

Figure 7. Government Interest Expenditure

Figure 7 shows interest expenditure disaggregated into its domestic and foreign components. As the country benefited from the Heavily Indebted Poor Countries (HIPC) initiative foreign interest payments as a proportion of total interest payments declined sharply.

Figure 8. Composition of Government interest expenditure

Figure 8

The key question is why debt servicing did exploded since 2001, after a string of years of apparent fiscal stability and during which major efforts had been made by the donor community to help the country overcome the foreign debt burden through the HIPC initiative. In the next paragraphs we bring some elements to substantiate this argument. All this occurred in the
background of a heightened demands on public expenditure at the onset of peace expenditure, in the background of the falling aid inflows that followed the period immediately after the end of the military conflict.

*a) Bailouts of failing commercial banks*

During the socialist experiment, state-owned banks and the treasury extended easy and cheap loans and subsidies to inefficient state enterprises. In the case of loans, neither the principal nor the interest due were ever recovered. As the civil war raged and companies were destroyed, the state effectively provided *de facto* war insurance, covering both replacement investments for equipment destroyed by war, and operating costs. Further, in the mid-1990s, eager to accelerate the enterprise privatization program and the liberalization of the financial system, the government extended treasury loans to potential buyers with no due financial diligence. Most of these loans were not (or still remain to be) repaid. The realized budgetary outlays of these risks are shown in Table 1. Bank bailouts amounted to a direct total cost of US$152 million in 2001 and 2002. This represented 84 percent of the total budgetary cost (US$182mn) resulting from the realization of the contingent liabilities associated with government involvement in the financial and non-financial sectors of the economy.

**Table 1. Realized fiscal risk of banking sector crisis: bank restructuring**

<table>
<thead>
<tr>
<th>Items</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>MTs</td>
<td>USD</td>
<td>MTs</td>
</tr>
<tr>
<td>1. Primary balance excluding bank bailouts</td>
<td>-5,530.0</td>
<td>-267.1</td>
<td>-4,759.0</td>
</tr>
<tr>
<td>2. Primary balance including bank bailouts</td>
<td>-6,914.8</td>
<td>-333.9</td>
<td>-6,790.0</td>
</tr>
<tr>
<td>3. Bank bailouts</td>
<td>1,384.8</td>
<td>66.9</td>
<td>2,031.0</td>
</tr>
<tr>
<td>In % of primary balance including bank bailouts</td>
<td>20%</td>
<td>30%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Memo:
Financial restructuring and shareholding responsibilities (“Saneamentos financeiros e participações”)

Total (including bank bailouts) | 1845 | 89.1 | 2197 | 92.8 | 100 | 4.2 |

of which: Other non-specified | 460 | 22.2 | 166 | 7.0 | 100 | 4.2 |

Average annual exchange rate (MT/USD) | 20,706.9 | 23,665.4 | 23,782.4 |

Sources: For 2001: Item 1 is from "Budget Execution Report 2001" (Relatório de Execução Orçamental), Mapa 21; and item 2 is item 1 plus the sum of amounts spent in the restructuring of BCM and Banco Austral, respectively 233.8 and 1,151.0, as reported on p. 19 of the same "Budget Execution Report 2001". For 2002: Items 1 and 2 are from "Budget Execution Report 2002", Mapa 25. For 2003 Items 1 and 2 are from "Budget Execution Report 2002", Mapa 27. Item 3 is the difference between items 1 1 and 2 (1-2). The Exchange rates are annual averages calculated from monthly averages given in Government "Budget Execution Report 2003", p. 48.

*b) Bank of Mozambique’s exchange rate related valuation losses*

In the context of the Bank of Mozambique organic law, unrealized foreign exchange related valuation losses represent a liability of the state treasury. This is recognized in the Balance Sheet of the Bank of Mozambique as “Unrealized exchange rate losses repayable by the State” or “Amounts due by the Government”. Since the enactment of this law, the Bank of Mozambique had included in its notes to the financial statements an indication that: “This [valuation
adjustment] balance [when a debit it] is required to be settled by the Government in accordance with the terms of Article 12(2) of Law 1/92.” Over a string of years the auditor responded in an equally short note, simply pointing out that “Despite the obligation of the State to settle this balance we did not receive a confirmation of the value reflected in the financial statements.” And with that the matter would be put to rest. The larger public never got to learn the implications of this exoteric language.

Meanwhile, already in December 1994, the balance of this account amounted to US$608.7 million, equivalent to 60.5 percent of the total assets of the Bank of Mozambique. In 2002, the item represented 40.5 percent of the total assets of the Central Bank. According to IMF calculations (Table 2/Panel A), “Valuation Adjustments” amounted to a staggering US $638.5 million in November 2002, representing 43.4 percent of total assets. Adjusting for this amount, the true net worth of the Bank of Mozambique was negative. When (if) and how this risk could materialize, was however not possible to ascertain. Financial experts agreed that whatever the solution, it would certainly involve some budgetary cost over a long period of time. Aside the potential direct budgetary implications, there have been policy and system wide implications feeding back into exchange rate, monetary and fiscal situation. We briefly address two of these issues below.

\[124\] With literally this wording, this was a recurrent footnote to Financial Statements of the Bank of Mozambique. Banco de Moçambique: Relatórios Anuais (Bank of Mozambique: Annual Reports), various issues 1984-2003. 
\[124\] The matter was first brought to the wider public through a string of articles authored by Roberto Tibana, published between September 2003 and November 2004 in the widely read Maputo-based daily fax publication MediaFax (No. 2859, 10.09.2003; No. 2981, 08.03.2004; No. 2982, 09.03.2004; and No. 3149, 03.11.2004).
First, backed by the fictitious nominal asset represented by “Valuation Adjustments” inflating its Balance Sheet, the Bank of Mozambique could embark on market interventions. These included the issuance of Central Bank and Treasury Bills to soak up perceived liquidity. This was combined with the hiking of the reserve requirements rates and was part of the authorities’ strategy of combating inflationary pressures perceived as mainly coming from the monetary side. One of the consequences was an enlargement of the inflation tax base and a further saddled commercial banking system. An adjusted income statement produced by the IMF at the time showed that the Bank of Mozambique would have not been perceived as profitable were it not for the inflation tax returns generated by increased inflation levels and volatility that ensued (Table 3).\textsuperscript{125}
Second, the existence of that fictitious asset in its balance sheet enabled the Central Bank (and the government) to resist the most sensible option of non-inflationary spending of aid which would have entailed selling aid dollars in the domestic market to mop up potentially aid spending-induced liquidity. This would also have had the advantage of stabilizing the nominal exchange rate, which would have helped combating inflation by alleviating the domestic currency cost component of imported goods. Well managed, this option would have allowed the authorities to better address the trade-off between real depreciation and inflation. A more gradual real depreciation would have been better in tandem with the reconstruction of the economic infrastructure and restructuring of the private sector to better take advantage of the implied gradual improvement in external competitiveness. To the contrary, most of real exchange rate depreciation occurred between 1990 and 1996 when the country was either still under the war or had just come out of it and the economy could not take advantage of the external competitiveness expected from exchange rate depreciation.\footnote{As the IMF point out (Country Report 04/52) even if this issue was resolved, the balance sheet of Banco de Moçambique would remain precarious and a constraint to the Bank’s ability to pursue flexible monetary policy as required.}

**Aid and macroeconomic policy coordination**

At the onset of peace, the developments in the exchange rate and aid created serious challenges to monetary, fiscal and exchange rate policy coordination. The depreciation of the national currency against the US dollar further increased the national currency value of the aid proceeds to government, but also increased the liabilities of the monetary authority as government aid proceeds were placed as deposits with the central bank. This required tightening of money supply, with a concomitant rise in interest rates and reserve requirements.

Mopping up the liquidity generated by the portion of aid that was spent also required the issuance of treasury bills which prevailed over the central bank instruments as the preferred tools of open market operations. This increased the liabilities of the government and created a channel for the drainage of public resources through interest payments, instead of channeling them to post war reconstruction and priority poverty reduction expenditures. To ease this, the Central Bank would have to create assets in the form of additional international reserves. However this would have the implication of increasing the scarcity of foreign currency in the economy, pushing up the nominal exchange rate.
Despite early suggestions about the advantage of using the sale of foreign currency as a toll for absorbing some of the liquidity while easing the pressure of the exchange rate, for a long period of time the authorities remained caught in the described web of fiscal-monetary-exchange rate inconsistency. Change in this direction came only when the issue elicited a “rebellion” from some bilateral donors (amongst a few that have occurred in Mozambique), who blamed the IMF-sponsored monetary and fiscal policies as detrimental to the country’s development by not allowing the spending of aid by the government and thus stifling the growth of the economy and slowing down the pace of poverty alleviation. The unions complained about the erosion of the purchasing power of their members’ earnings as the exchange rate depreciated and imported inflation soared. The business community was also up in arms due to the higher cost of borrowing to finance increasingly costly imported inputs. The depreciation of the currency vis-à-vis the US Dollar was favoring exports to and investment from the “dollar zone”, while discouraging imports from there; concomitantly appreciation with respect to the SA rand was discouraging exports to and investment from the “rand zone” while subsidizing imports from there. So eventually, and belatedly reserves built out of aid proceeds that were not immediately spent were used just for the purpose of smoothing out the exchange rate.

CLOSING REMARKS

This paper studied Mozambique’s experiences of transition from war to peace and the macroeconomic policies of the immediate post-conflict development.

It can be said that in the two transitions from war to peace that Mozambique has undergone, flexible power-sharing arrangements contributed to the successful ending of war and to building peace. Both cases of transition share in common the success of FRELIMO in keeping the upper hand over rivals in the struggle to control political, military, security and economic power. In this context, the power-sharing arrangements that came out of the Rome Peace Agreements succeeded in bringing a lasting peace mainly because they provided FRELIMO with the means to neutralize RENAMO as a war machine. This was achieved through concessions and agreements between the former belligerents. Some of them were clearly against constitutional and democratic principles, such as allowing armed men controlled by a supposedly political party. Others were clearly illogical such as RENAMO’s tacit agreement to leave intact and in the hands of the FRELIMO Government the almighty intelligence services. Nonetheless, they were pertinent to ensuring a peaceful transition from war to peace. However, the fact that the same mechanisms that allowed FRELIMO to neutralize RENAMO as a war machine have also been used to subsequently destroy it (and other political parties) as an effective political opposition casts doubt on the genuineness with which FRELIMO is ready to allow a future of peace founded on democratic values.

Thus, on the one hand, Mozambique’s experiences of power-sharing, and, in the case of the last transition, trust-building arrangements impacted positively to national development in that they contributed to end the civil war and prevent its resumption. On the other hand, they seem also to have had the negative effect of building precedents of undemocratic structures that seem to have established a vicious circle of increasing interference of political parties in the administrative apparatus of the state and, most damagingly, by politicizing and undermining the independence of the institutions of the electoral process.

The efforts to bring a lasting peace to Mozambique became closely intertwined with the developments in the economy. By the mid-1980s, pervasive state controls of the economy and
expansionary policies of the socialist-type regime had failed to generate economic growth, limiting the domestic resource base to sustain the civil war. This was aggravated by the collapse of the socialist regimes of Eastern Europe and the Soviet Union, as it resulted in the curtailment of external funding to the economy and in military supplies. The two were inter-related as military supplies from the “socialist allies” often came as a result of barter trade and long-term loan agreements, which the collapsing domestic economy could no longer guarantee. Orthodox macroeconomic stabilization and structural adjustment were therefore forced on the country as an overriding condition to access external assistance from the West as the only alternative to total collapse. They thus became critical elements of an overall economic and political regime change. In this context, Mozambique offers a unique case in history when (to our knowledge) orthodox macroeconomic stabilization was undertaken in a war environment. History and economic theory would have suggested expansionary macroeconomic policies to respond to war demands. However by the late 1980s and early 1990s, for both internal and external reasons, the space for this policy stance had been exhausted.

Macroeconomic policy during the critical years of transition from civil war to peace was fundamentally influenced by the constraints imposed by the imbalances inherited from the socialist-type regime, and the need for physical and monetary reconstruction from the destruction brought about by the war. Moreover, the requirements of orthodox stabilization and limited aid inflows tightened the authorities’ space for maneuver in addressing these challenges. While the government was successful on the conventional measures of fiscal consolidation and discipline, substantial fiscal risks built up and leakages occurred that meant that not all the resources available would be channeled according to the priorities of post-war reconstruction and poverty alleviation. Amongst these risks, exchange rate volatility and contingent fiscal liabilities became critical. Their realization affected the ability of the macroeconomic agencies to perform an effective role in steering the economy and in particular the financial system to perform a more positive role in development. Some of the issues of fiscal-monetary coordination that affected the effectiveness of monetary and fiscal policy making in Mozambique during the 1990s and early 2000s arose from the realization of these risks.

With regard to aid, its decline at the onset of peace meant that it was not sufficiently available when it was most necessary. One of the results was the delay in the reconstruction of infrastructure, and thus in the recovery of private sector activities. This also meant a delay in the necessary monetary reconstruction. When aid resurfaced, it was insufficiently spent, given the tight fiscal contention under the IMF sponsored program. In the meantime, tight monetary policy was facilitated by the capacity of the monetary authority to conduct interventions backed by balance sheet assets that only represented accounting government liabilities, while resisting selling aid dollars. Although this assisted the accumulation of reserves, it is still an open question whether the price paid in terms of exchange rate depreciation and the macroeconomic instability (high and volatile inflation) at the onset of peace was worth it. Considering that inflation hurts the poor the most and is bad for investment, two ills to be avoided particularly at the onset of peace following a long civil war that drove investment out, it should have been avoided. It is ironic that although under the watch of the IMF and for fears of inflation there was no expansionary monetary policy as a means to pump-prime post-war reconstruction and development, inflation was not avoided for reasons of inconsistencies of the macroeconomic policies adopted and the problematic sequencing of aid.

Given the overall success the power sharing arrangements in sustaining peace and the undeniable benefits to growth of the dismantlement of the socialist type regime, neither the
remaining democratic deficit nor the conflicts and inconsistencies of macroeconomic and growth policies can discredit the progress made by Mozambique in her quest for peace and development over the last two decades. However, the cracks are beginning to appear. They lead to further research issues which, for reasons of space, have not been addressed in this paper but which are critical to understanding post-civil war developments and the future of peace in Mozambique. Amongst these are the issues of how a post-civil war growth strategy based on mega-projects and a capital intensive natural resource sector has reversed the early post-war gains in poverty reduction and has created an environment of social insecurity with large sections of the population (particularly the young) marginalized from the process of development and its benefits.

POLICY IMPLICATIONS

On the political dimensions

- Power-sharing can be crucial to peaceful transition from war to a lasting peace founded on democratic principles and inclusiveness. Its immediate focus should be on building trust and confidence amongst belligerents, for them to commit and effectively engage in building peace. The experience of Mozambique shows the need to avoid the pitfalls of trust and confidence building mechanisms that border on sacrificing democratic principles.

- Structuring the mechanisms of power-sharing is a delicate process requiring careful balancing of the immediate focus on trust building to achieve the cessation of hostilities with the long term goals of a lasting peace and democracy. The experience of the two transitions from war to peace in Mozambique shows that successful power-sharing in this sense need not, and indeed should not, focus uniquely and strictly on sharing ministerial positions. The specific power-sharing mechanisms that will emerge from the peace process will depend on the specific nature and history of the conflict and the dynamics of the peace process.

- To avoid creating the institutional distortions, power-sharing arrangements should be time bound and have built-in exit strategies that will ensure the emergence and flourishing of independent democratic institutions imbued with integrity to safeguard transparent and inclusive political processes. In Mozambique, this was partly achieved through a process of constitutional reform/amendments to enshrine democratic principles agreed during the peace negotiations. The country’s democracy is, however, still saddled with remnants of less inclusive arrangements that were part of necessary transitional compromises that crept into the way the post-civil war political institutions and practices evolved, with potential risks to political harmony, lasting peace and development.

On the economics of transition and post conflict development

- The principal economic task at the onset of peace is to undertake two types of inter-related reconstruction: a) physical reconstruction of economic infrastructure to facilitate the resumption of growth, trade, exports and employment; and b) monetary reconstruction to minimize inflationary risks that would hurt the poor and impede rapid resumption of investment and growth.
Success in this two-pronged economic reconstruction requires well-coordinated and sequenced monetary, fiscal, and exchange rate policies with focus on growth. Because the post-conflict fiscal space is likely to be limited, external aid will play a critical role in both reconstruction processes. Particular attention should also be given to monitoring contingent fiscal abilities that tend to develop during the war and transition and to devising solutions to avoid exhausting limited future fiscal resources needed for reconstruction and development expenditure.

Depending on the specific country circumstances in terms of economic regime at the onset of peace, the following would be advisable: a) avoid orthodox stabilization measures likely to be pushed by International Financial Institutions, which would have the effect of undermining consumption and investment demand needed to facilitate growth; b) seek to boost revenue to sustain increased expenditure while avoiding increased borrowing which is likely to be excessively expensive as lenders factor in conflict risk and pray on a weak government debt management capability; c) spend and absorb aid; the appropriate fiscal-monetary-exchange rate policy mix underlying the effective use of aid in the post-conflict setting will most likely entail the domestic sale of aid dollars as a means of simultaneously boosting absorption while addressing potential inflationary pressures; and d) avoid exchange rate depreciation partly to minimize imported cost push inflation, and also because it would tend to build revaluation assets and liabilities with negative effects on the conduct of monetary and fiscal policies.
REFERENCES

18. “Real /Excahge Rate Misalignment in SSA: How Serious, How Dangerous?”, !!!!!!!!
Democratization, Poverty Reduction, and Risk Mitigation in Fragile and Post-Conflict States: A Case Study of Post Genocide Rwanda

Herman Musahara\textsuperscript{127} and Euthalie Nyirabega\textsuperscript{128}

**ABBREVIATIONS**

- BCR: Banque Commerciale du Rwanda
- BWIs: Bretton Woods Institutions
- COMESA: Common Market for Eastern and Southern Africa
- DIP: Decentralisation Implementation Programme
- DRC: Democratic Republic of Congo
- EDPRS: Economic Development and Poverty Reduction Strategy
- EICV: Enquête Intégrale sur les Conditions de Vie des Ménages
- ESAF: Enhanced Structural Adjustment Facility
- EU: European Union
- FDI: Foreign direct investment
- Frw: Rwandan franc
- GDP: Gross domestic product
- GNI: Gross national income
- GoR: Government of Rwanda
- HIPC: Highly indebted poor countries
- HIV/AIDS: Human immunodeficiency virus/acquired immune deficiency syndrome
- ICT: Information communication technology
- IDA: International Development Association
- IDRC: International Development Research Centre
- IIDS: Institute for Studies of International Development
- IMF: International Monetary Fund
- ISID: Institute for the Study of International Development
- MDGs: Millennium development goals
- MINALOC: Ministry of Local Government, Community Development and Social Affairs
- MINECOFIN: Ministry of Economic Planning and Finance
- NURC: National Unity and Reconciliation Commission
- NTB: National Tender Board
- ODA: Overseas development assistance
- PETS: Public Expenditure Tracking Surveys
- PFP: Policy Framework Paper
- PRGF: Poverty Reduction Growth Facility
- PRSP: Poverty Reduction Strategy Paper
- UNDP: United Nations Development Programme
- RDF: Rwanda Defense Forces

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INTRODUCTION

In this case study, two issues are generally notable. First, the dynamics of post-genocide policy and economics in Rwanda show evidence that within a period of 15 years, considerable economic and political stability and substantial success in reconstruction and reconciliation have been attained. Second, multiple post-conflict reconstruction variables must be considered, including analyses of power-sharing experiences, governance, decentralization, and poverty reduction. Ample lessons can be learned from studying how each type of activity contributed to the overall post-conflict development effort in Rwanda.

The pillars of the case study are threefold, as defined by a common methodology that cuts across all case studies: the analyses of power sharing, participatory governance, and the post-conflict economic agenda. In the case of Rwanda, all three pillars support one conclusion, which is that relative stability and peace building have been the products of policy initiatives, democratization, decentralization, and poverty reduction. These efforts have mutually reinforced each other for maximization of economic gain and minimization of conflict. The first two parts of the case study contain an adequate description of some of these efforts and outcomes. Nonetheless, long-term peace building necessitates addressing several tradeoffs and competing priorities that have hitherto characterized the Rwandan post-conflict transition. Economic reconstruction continues to be characterized by competing policy priorities.

We draw several lessons from the Rwandan case that should inform other models on post-conflict analyses. We hope that the same lessons may enrich the search for sustainable peace and economic development within Rwanda. These lessons are presented at the end of this report.

The rest of the report has six sections. Section 2 gives general background information on the country. Section 3 discusses findings on power sharing, and section 4 provides information on participatory governance. Section 5 is a summary of findings on the post-conflict economic agenda. Section 6 outlines possible lessons to be drawn from the case study of Rwanda.

BACKGROUND OF THE CASE COUNTRY

Rwanda is a landlocked Central African country bordered to the north by Uganda, to the east by Tanzania, to the west by the Democratic Republic of Congo, and to the south by Burundi. The land surface of Rwanda is 26,388 square kilometers and it holds a population of 10 million (government estimate is 10,117,029 for 2009). The population density is 377 people per square kilometer, one of the highest in sub-Saharan Africa.

About 90 percent of the population lives in rural areas, and a majority of these depend on agriculture. The agricultural sector is the backbone of the economy, contributing about 41 percent of gross domestic product (GDP) and more than 72 percent of all exports. Rwanda’s traditional cash crops are coffee and tea (www.minecofin.gov.rw).

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129 See www.statistics.gov.rw
Rwanda has a small industrial sector that produces a range of consumer goods, especially beverages, foodstuffs, and textiles. Industry contributes 21 percent to GDP. The service sector contributes 35 percent, a slightly larger share than industry but lower than agriculture (www.minecofin.gov.rw).

Rwanda’s history is marked by a legacy of conflict originating from quasi-ethnicity and forged and nurtured by colonial rule. While the conflict is generally regarded as a long-term conflict between Hutu and Tutsi, the proximate causes of conflict were tension between social groups and elite competition over resources and power in the period leading to genocide. Ethnicity was only a mechanism through which the grievances of the groups were vented. The culmination of hostile and tense relations was a four-year civil war from 1990 to 1993 and the genocide in 1994. As a civil war, it was short relative to other conflicts, but its genocidal end made it a high-intensity conflict with post-war consequences of immense magnitude, including the following:

1. More than 1 million Tutsi and moderate Hutu in opposition were killed, and about 3 million were forced into exile in neighboring countries, including Tanzania, Burundi, Democratic Republic of Congo (DRC), and others;
2. A high proportion of households are headed by women, many of them widows. In 1995 34 percent of households were headed by women, 21 percent of which were widows of genocide. Men form the minority of the adult population in Rwanda;
3. The war and genocide left about 85,000 child-headed households;
4. It is estimated that in 1995 about 96 percent of Rwandan children had observed violence, while 70 percent witnessed someone being killed or injured;
5. About 140,000 people were imprisoned for genocide-related crimes, imposing a large economic burden on the state and on their households;
6. The experience of violence traumatized a high proportion of the population and led to a deprivation that could not be captured by ordinary poverty measurement methods;
7. Shelter and capital stock were drastically reduced both in the household and small business sectors;
8. Networks of social links, for instance, between rural and urban areas, were damaged, impeding internal commerce;
9. The prevalence of HIV/AIDS increased dramatically; up to 11.2 percent of the total population had HIV/AIDS in 1995 As of 2010 the figure had dropped to 3 per cent;
10. Human resources were drastically reduced. In 1995 79 percent of core civil servants had not completed secondary education (GoR 2007 and Statistical Annual Report 2009).

130 It is regarded as quasi-ethnicity because Tutsi, Hutu, and Twa, the three principal groupings, speak the same language, once lived on the same hills, and have a single culture. The Tutsi were traditionally regarded as aristocratic, tall cattle keepers and by 1960 constituted no more than 10 to 15 percent of the population. Hutu are relatively more stocky, dominantly agricultural and by the 1960s constituted somewhere between 85 and 90 percent of the population. The Twa are short, pygmyoid, and dominantly hunters and fruit gatherers; they did not exceed 5 percent of the population and never ostensibly participated in the polarized politics of Rwanda. Other elements distinguishing the groups are noted in this report. (For a detailed account see Prunier 1995.)
In a period of less than two decades, Rwanda has managed to recover to a significant extent. The average growth of GDP has been above 6 percent per annum since 2000, and poverty has declined from 78 percent of the population earning below the equivalent of US$1 per day (a general estimate of absolute poverty) in 1996 to less than 60 percent earning that amount in 2006. The per capita average annual income has doubled, from less than US$250 in 1996 to more than US$500 as of 2010. The country has a good record of promoting external (foreign) investment and in 2008 passed legislation supporting extraordinary policy reforms for sustainable development. For instance the policies to improve the investment climate have resulted in Rwanda being rated among the best countries in Africa for doing business with foreign investors. Whereas Rwanda would have qualified as a failed state in the first half of 1994, by 2009, only 15 years later, it was regarded as a success story of peace building, reconciliation, and reconstruction (Statistical Annual Report 2009).

Rwanda’s experience of post-conflict transition can offer lessons to both the South and the North. This is in relation to the Rwandan power-sharing attempt, the experience with decentralization and democratization, and the macroeconomics of the post-conflict transition. It is also related to how the North may align aid for longer-term peace building and risk mitigation.

POWER SHARING IN RWANDA

Background to the conflict in Rwanda

To understand the power-sharing initiatives requires an appreciation of the historical nature of the Rwandan conflict. While the power-sharing process is hinged on agreements between the Government of the Second Republic and the Rwanda Patriotic Front (RPF), one has to understand why the two warring forces were diametrically opposed at the beginning of the 1990s. The answer lies in the immediate history of Rwanda.

The pre-colonial era in Rwanda (1500 to 1885) was characterized by a highly centralized kingdom presided over by Tutsi kings who hailed from one ruling clan, the Nyiginya. The relationship between the king and the rest of the population was unequal, but relationship among ordinary Hutus, Tutsis, and Twa—the three major quasi-ethnic groups—was one of mutual benefit, mainly through the exchange of their labor. The relationship was symbiotic. A clientele system called “Ubuhake” permeated the whole society.

In 1899 Rwanda became a German colony. After the defeat of Germany during the First World War and subsequently in 1919, Rwanda became a mandated territory of the League of Nations under the administration of Belgium. Germany and Belgium both administered Rwanda through a system of indirect rule.

In 1935, Rwanda became a Belgian colony. During this period colonial administration introduced a discriminatory national identification system on the basis of ethnicity most

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131 Second Republic has been used to refer to the regime that took over power in 1973, a second after independence. It was the regime headed by President Habyarimana, under which genocide was later committed in 1994.

132 The distinctions between Hutu and Tutsi noted above were sharpened and institutionalized by the colonial regime in the 1930s for political and economic purposes. Although the designation “Tutsi” was used to describe the aristocracy, the Tutsi people did not constitute a homogeneous entity. Among several of its clans, only the Nyiginya clan ruled. A Hutu could qualify as Tutsi simply by owning more than 10 cows (see Prunier 1995). Of course, Prunier and other authors analyse also other methods used by the Belgians to distinguish the different groups. These included height and the shape of the nose, with Tutsi being taller, slender with long noses while Hutu were classified as Bantu - stocky, short and with brunt noses.
motivated by the principle of divide and rule. The Belgians mistakenly assumed that Tutsis were those who possessed ten or more cows and the Hutus were those who owned fewer or no cows. The Twa were a third group that is rarely referred to in the discourse of ethnic conflict in Rwanda mainly because they formed a small proportion of the population then estimated to be less than 2 per cent. The Belgian system favored the king and his chiefs, who were mostly from the Tutsi ruling elite. However, as soon the Tutsi began to demand independence, they lost the Belgians’ favor. When the Tutsis began to demand independence while the Belgians were still supervising the country, the first massacres of Tutsis at the hands of the Party of the Hutu Emancipation Movement (PARMEHUTU), a Hutu-dominated party, occurred in 1959. With Belgian connivance, PARMEHUTU abolished the monarchy amid widespread violence. Hundreds of thousands of Tutsis were massacred, and many others fled to neighboring countries. On July 1, 1962, Belgium granted formal political independence to Rwanda.

Rwanda became a Republic in 1962. The First Republic existed until 1973 under the leadership of Grégoire Kayibanda as the president. Kayibanda, a Hutu, had been the leader of the Parmehutu. The First Republic institutionalized discrimination against Tutsis and periodically used massacres against these targeted ethnic members of the population. The First Republic was characterized by fairly systematic violence. To save their lives, large numbers of the Tutsi ethnic group formed Diasporas in other countries. The exiled Tutsis attempted on several occasions, but without success, to stage armed comebacks. In 1965, Rwanda was declared a one-party state under MDR-Parmehutu, which had steadily dominated then ruthlessly killed members of other political parties. In 1973, President Grégoire Kayibanda was deposed in a coup d’état by Major General Juvénal Habyarimana. The coup resulted in the creation of a regime usually referred to as the Second Republic. Habyarimana had called for a change of government due to excessive discrimination against Tutsis and opposition political parties by the First Republic. The Second Republic’s leadership operated in the same ways as the First, though the targeted group became the Hutus. Besides killing prominent Hutu politicians, the coup set off another wave of massacres of Tutsis, a phenomenon that was repeated during the Second Republic. In the aftermath of the coup, large numbers of Tutsis were forced to flee Rwanda once again. It is important to note that although the initial divisive line was between Hutu and Tutsi in both regimes, new forms of discrimination arose. In 1975, the “Mouvement Révolutionnaire Nationale pour le Développement (MRND),” a single ruling party under the leadership of Major General Habyarimana, was established. Political control became more centralized, and discrimination against Tutsis was institutionalized. Tutsis were not allowed access to political positions, to secondary and higher or higher education, nor were they allowed to own business.

However, Rwandans in exile, mainly the Tutsi Diasporas, spoke out during the First and Second Republics on several occasions and demanded to return to Rwanda. The authorities

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133 It is often argued that the group of Belgian rulers in Rwanda in the late 1950s had regarded the Tutsis as having outwitted them by looking for independence and then switching sides. Others believe a majority of the Belgians were themselves aware of similar animosities in Belgium between the Walloons and the Flemish and feared that Hutus would be perpetually subjugated to Tutsi rule after independence.

134 As cited in Gasarasi Charles and Shyaka, Anastase (2008, 45), in May 1960, PARMEHUTU changed its name to MDR-Parmehutu in response to Belgian and Catholic Church pressure because the original name in capital letters was too blatant a reminder of the past racial/ethnic (Hutu) exclusion, which some members of the international community found unpleasant.

135 The name refers to one party (not a merger), roughly meaning a Republican Democratic Movement. The second part emphasized that it was a party for emancipating the Hutu, one of the ethnic groups that had overthrown the monarchy.
(notably President Habyarimana) advanced the argument that “Rwanda was a small and overpopulated” country that could not accommodate all Rwandan refugees if they were to return to their country. The refugees’ persistent demands to return and the persistent refusals of the regime preceded the escalation of conflicts in Rwanda in early 1990s. In October 1990, a group of Rwandan exiles under the banner of the Rwanda Patriotic Front (RPF) invaded the country from Uganda with the sole aim of forcing the regime to recognize the right of Rwandans outside the country to return.

In the meantime, Rwanda’s dictatorial regime, dominated by military officers from the home district of President Habyarimana in the North, exercised a more centralized style of control. The pressure for democratization and multiparty politics continued to test the regime’s power. When war broke out in 1990, the regime interpreted the conflict as a Tutsi attempt to regain power in Rwanda.\textsuperscript{136} The RPF side demanded that refugees be allowed to return and that democratization, the rule of law, government accountability, subsequent sharing of power in a determinate political framework be established. The government side maintained that the Tutsi were determined to regain power and would possibly seek revenge. This stance was useful in rallying the people behind the regime. It is noteworthy that several disgruntled groups had developed during the 20-year reign of the Second Republic. Once again the persecution of Tutsis fuelled a heightening of ethnic feuds and hatreds, especially among radical Hutu groups, all of which led to the genocide of 1994.

Negotiations and search for peace in the context of war: The Arusha Agreement as the Power-sharing Model of Rwanda

Following the October 1990 invasion, a series of negotiations between the RPF and the apparently decaying regime began almost immediately. The product of the first negotiation was the N’sele Ceasefire Agreement, signed on March 29, 1991. This negotiation took place in and was facilitated by the Democratic Republic of Congo (DRC) in a place called N’sele. The agreement provided for, among other things, cessation of hostilities, withdrawal of foreign troops, an exchange of prisoners of war, and serious political negotiations to end the conflict. Immediately after the agreement was signed, however, the war intensified, and more pressure from regional leaders and the international community was brought to bear on the warring parties to come to a peaceful understanding (www.gov.rw).

After a long period of intensive negotiations between the government of Rwanda and the RPF, which took place in Arusha, northern Tanzania, a peace deal to end the conflict was agreed upon, and the Arusha Peace Agreement was signed on August 4, 1993. The agreement was supposed to be implemented within 37 days; however, unfortunately, the agreement was never implemented within the framework that had been designed at the negotiating table.

Article 54 of the Arusha Peace Agreement provided for acceptance of a multiparty democracy. This was a challenge to the one-party, dictatorial regime to change course. Newly formed political parties started to align themselves for positions in a broad-based government as

\textsuperscript{136} While this would appear to be the intention, since the majority of refugees living outside Rwanda in the 1950s and 1960s were Tutsi, the RPF had carefully defined an ideological position that would not let the movement fall into the trap GoR was setting. Instead, the RPF focused on addressing the entire set of governance problems created by the regime, including divisionism by regions, dictatorship, and failure to recognize the right of Rwandans outside the country to return. Indeed, the first and second chairpersons of the RPF were Hutu, proof that it was not an exclusively Tutsi movement.
set forth in the agreement. Radicals\textsuperscript{137} in the regime became embittered and alienated from the regime and opposed the formation of a broad-based government. The new parties started to put pressure on President Habyarimana to change, while regional leaders and the international community pushed him to respect the outcomes of the Arusha Agreement. After one of several meetings with heads of state of the region in Dar es Salaam, Tanzania, President Habyarimana and President Cyprien Ntaryamira of Burundi were flying back to Rwanda on the evening of April 6, 1994. Near Kigali, their plane was shot down, and both presidents and the entire French crew died. The new, broad-based government defined in the Arusha Agreement did not form. That same night the genocide began.

Genocide against the Tutsi in April 1994: The Failure of the Arusha Agreement\textsuperscript{138}

Between April and July 1994, more than 1 million Rwandan people, mainly Tutsis and moderate Hutus who were in opposition to the dictatorship, were killed by groups opposed to regime change. This was not a spontaneous action caused by the shooting down of the presidential plane. Careful preparations in opposition to the Arusha Peace Agreement had been made. Preparations to carry out genocide by these groups involved training of the militia, arming of the militia and some sections of the population, establishment and widespread use of a hate radio station called Radio Télévision Libre de Mille Collines (RTLM), and distribution of lists of those who were to be targeted. In only one hundred days, more than 1 million Tutsis and moderate Hutus were killed by a militia group called the Interahamwe.\textsuperscript{139} The breakdown of the agreement and the beginning of the genocide led to the RPF’s open campaign for an all-out war to stop the genocide and to topple the regime. When the genocide began, the United Nations had a peacekeeping force of about 2,500 troops in place, called the United Nations Assistance Mission for Rwanda (UNAMIR). The first reaction of the United Nations and of other nations whose nationals were living in Rwanda was to withdraw their troops and their citizens, leaving unprotected Rwandans to the genocide forces and militia. This gave the RPF further reason to advance against the army of the regime and to march toward Kigali, the capital city. By July 4, 1994, Kigali had fallen to the forces of the Rwanda Patriotic Army (RPA), a rebel army and military wing of the RPF. A new government was formed, and after some years the RPA became the Rwanda Defence Forces (RDF). The economic and social dimensions of the genocide are reviewed in a separate section of this chapter.

Post genocide political power sharing and revival of the Arusha Agreement\textsuperscript{140}

\textsuperscript{137} It is worth noting that the more radical members of the regime tended to favor political parties based on the ethnic groupings of Hutu versus Tutsi. The parties reflecting political interests are diverse. Today the parties are RPF (patriotic front), PL (liberal party), UDPR (Democratic union), PDI (Democratic Islamic), PSD (Social Democratic), PDC (Christian Democratic), PSR (Socialist), and PPC (progress and concord). More details are available at www.forumfp.org.rw.


\textsuperscript{139} Ironically, Interahamwe is a Rwandan term, the traditional name of an army that attacks in unison. The term now refers to Rwandan \textit{genocidaires} (those guilty of leading and organizing the genocide).

\textsuperscript{140} The material in this section comes from C. Garasari and A. Shyaka, 2008, \textit{Performance of Past and Present Political Parties}. 
Once the RPF stopped the genocide, the power-sharing parties had to determine a way of working together to run the country. Except for the parties directly involved in committing genocide, all others were invited to participate in the new government. Although no party or group attempted to enforce the Arusha Agreement to bring peace during the summer of 1994, the terms of the agreement were used to guide political power sharing after the genocide.

A proposal in the Arusha Agreement recommended that a consensual arrangement be devised to define power sharing. Based on that proposal, a “consultative forum of political organizations,” referred to as the Forum, was created and continues to be operational. It consists of a committee representing all active political parties. The committee meets regularly to regulate the parties and prevent ethnic cleavages from developing among them. The Forum provides a platform for inter-party consultations and analyzes behaviors and attitudes of party members in the performance of their functions at all levels of government. The Forum became prominent in the governing phase, referred to as the Transitional Broad Based Government, from 1994 to 2003. The success of the transitional period, particularly during its first five years, was partly due to the Forum’s active participation in governance of the country. The organization of the Forum and the Transitional Broad-Based Government were generally formalized as organic law No. 16/2003 of 27/06/2003, governing political parties and politicians. The end of the transition was capped by a referendum that culminated in drawing up a new Constitution, which was approved in 2003. The Forum has been retained since the transition as a mechanism for inter-party consultations. In February 2005, a professional code of conduct to guide political parties was passed and is one of the instruments the Forum continues to use. Although there have been occasional allegations that Rwanda has been governed autocratically or represively by President Paul Kagame and the RPF, though decentralization (discussed below) means making sure power is shared rather than concentrated in one person or party, its opposite is not the concept of a central government especially from scholars and politicians opposed to the current administration, the creation of the Forum to oversee consultations among parties was in itself positive. How those consultations could have been more effective is another issue relating to how the Forum has handled its business in light of multiple interests.

Power sharing is a concept at the core of peace making and peace building and has spurred the development of sophisticated models, which were not implemented fully in Rwanda. However, Rwanda’s experience demonstrates that power sharing is not linear or simple because it involves multiple parties and variables in addition to the primary negotiators. Above all, Rwanda demonstrates that a well-thought-out model supported by credible political and military forces can also crumble. Moreover, Rwanda has shown that after a first round and disastrous breakdown of power sharing, it is possible to pick up pieces and use them for post-conflict peace building even in areas of the model that failed when they were first attempted. In other words, there are specific principles in the power-sharing initiatives that remain durable and are likely to be used sooner or later.

1899     Rwanda became a German colony
1919     League of Nations mandated Rwanda a territory of Belgium
1935     Rwanda declared a colony of Belgium
1959     Tutsis campaign for independence; Belgians and Parmehutu kill many Tutsis
1962     Rwanda becomes a Republic
1962–1973 First Republic or government under Gregoire Kayibanda
PARTICIPATORY GOVERNANCE

Introduction

This section on participatory governance contributes to the thrust of the paper in two ways. First, the role of participation in a post-conflict transition needs to be underlined. In the case of Rwanda, exclusion from politics and economics is regarded as one of the critical features of the genocidal regime. Participatory governance in a post-conflict situation ensures inclusiveness and expands the possibility of sustaining peace.

Second, participatory governance seems to be a central element in current policy reforms in developing countries worldwide. However, its importance in post-conflict transitions and its links to post-conflict economics has not been explored. This section covers these two as one theme. Under the topic of decentralization is also the question of how a participatory governance approach can enhance service delivery. Regarding economic management policy reforms, the argument is that Rwanda has invested in participatory governance in its post-conflict agenda. While considerable material can be analyzed on participatory governance in Rwanda, our focus has been on case projects involving homegrown innovations that have placed participation center stage. While stylized facts about participatory governance can be assembled from any current study, our emphasis here has been on innovations in Rwanda that point to the role of participatory approaches in post-conflict contexts.

Good governance as participatory governance

The Government of Rwanda (GoR) defines good governance as: “the exercise of political, economic and administrative authority to manage the nation’s affairs and the complex mechanisms, processes, relationships and institutions as well as leadership behavior through which citizens’ groups articulate their interests, exercise their rights and obligations and mediate their differences” (GoR 2002). The unit in charge of good governance in the Ministry of Local Government, Community Development and Social Affairs (MINALOC) is responsible for promoting the culture of good governance toward the fight against poverty.

There has been a drastic shift toward use of the principles of good governance in post-conflict reconstruction. Participatory governance and decentralization as key elements of development discourse started with the World Bank’s conceptualization of good governance in the 1980s, but was not put into practice in Rwanda until recently, particularly in the period after
the year 2000. Understanding and believing that citizens indeed have power and can exercise their own power to act and be proactive citizens are new concepts to most Rwandans. These democratic concepts are contained in *Rwanda Vision 2020*, officially released as a document in 2002. Good governance in Rwanda is recognized as essential for poverty reduction, recognition of basic human rights, peace building, and economic growth and is the hallmark of Rwanda’s post-conflict policy response.

**Decentralization**

In May 2000, the government of Rwanda adopted a national decentralization policy to achieve three main goals: good governance, pro-poor service delivery, and sustainable socioeconomic development. It has been the general contention that bad governance, extreme poverty, and exclusive political processes were factors among the causes of the genocide (World Bank 2005).

The decentralization implementation program has three phases. The first phase (2000–2003) consisted of putting in place a number of legal, institutional, and policy reforms. These consisted of human capacity building in public administration and service delivery at local levels. Local councils were elected; relatively skilled personnel were deployed in local governments; and participatory, people-centered initiatives, such as working collectively to solve local problems (*ubudehe*), establishing a fair judicial system (*gacaca*), forming community development committees, and forming mediation committees (*abunzi*), were operationalized. These initiatives and their achievements will be discussed in more detail later in this chapter.

The second phase (2004–2008) was intended to consolidate and expand the decentralization processes by emphasizing service delivery to communities through a well-integrated accountability network. This is done by empowering communities through greater participation and involvement in the planning and management of their affairs. Through district performance contracts (*imihigo*), decentralization becomes an instrument for people’s political empowerment, reconciliation, social integration, and well-being. In Rwanda, decentralization is understood as a platform for sustainable democratization and a structural arrangement for mobilization of economic development energies, initiatives, and resources. It is intended to give power to the people and to enable them to execute their will for self-development. Thus, the first phase created power-sharing institutions, and the second has been consolidating accountability and empowerment of stakeholders. The latter has involved formation of homegrown models that make the process more people-friendly. Some of the models are discussed in the next section.

The key character of the second phase has been enabling local people to participate in initiating, planning, implementing, monitoring, and evaluating local projects, such as water supply, road construction, local trade, promoting cooperatives, and associations assessing their local needs and priorities, taking into consideration available resources. The underlying wisdom behind decentralization is to uproot the elements of exclusion that characterized governance by regimes before the 1994 genocide. The third phase is a continuous process of improving, supporting, and sustaining the achievements of the first two.

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141 *Vision 2020* is an ambitious government program to move Rwanda from the list of poor countries to a middle-income economy by year 2020. With targets and figures, it also identifies good governance, a knowledge-based economy, and human development as pillars of the vision (see GoR 2002).

142 *Imihigo* is a tradition and cultural practice that Rwanda has institutionalized as a means to enhance local government reform and stimulate development. Imihigo strengthens accountability and transparency by making local leaders and their initiatives directly accountable to the communities they serve and the central government.
Cases of reconstruction and peace building projects in Rwanda

National unity and reconciliation

According to the Constitution of the Republic of Rwanda, the mission of the National Unity and Reconciliation Commission (NURC) is to strive for a peaceful, united, and prosperous nation. The mission includes more specific objectives, such as preparing and coordinating national programs for the promotion of national unity and reconciliation; developing and putting in place ways and means to restore and consolidate unity and reconciliation among Rwandans; educating and mobilizing the population on matters related to national unity and reconciliation; carrying out research, organizing debates, disseminating ideas, and making publications related to peace, national unity, and reconciliation; and making proposals on measures that could eradicate divisions among Rwandans and reinforce national unity and reconciliation.

Other objectives include denouncing and fighting against acts, writings, and utterances that are intended to promote any kind of discrimination, intolerance, or xenophobia, as well as issuing reports annually and at any other times when national unity and reconciliation are threatened. One model used by the NURC that is embedded in Rwandan social capital is ingando.\textsuperscript{143}

Ingando

When the NURC was established, it formally developed solidarity camps as a tool to encourage coexistence within and among communities of Rwandans. Solidarity camps, held for weeks or months, combine political lectures, discussions, and paramilitary drills. They are usually tailored to suit the type of people in the camp. One camp may have several hundred citizens, while others can accommodate thousands.\textsuperscript{144}

The first people to benefit from the ingando exercise were former combatants from the DRC. The program later expanded to include thousands of students who were preparing to join universities and other institutions of higher learning in Rwanda. In 2002, the ingando were extended to serve informal traders and other social groups, including genocide survivors, prisoners and detainees, community leaders, opinion leaders, women, and youth. Today, ingando are held countrywide, and most are co-facilitated with communities. Common themes in ngando have included analysis of Rwanda’s problems; history of Rwanda (pre-colonial, colonial, and post-colonial); and political and socioeconomic issues in Rwanda and Africa, such as rights, obligations, duties, and leadership.

Gacaca

\textsuperscript{143} Ingando is a Rwandan term for solidarity camps that are used to impart civic education and inculcate values of reconciliation.

\textsuperscript{144} By 2005, 3,918 released prisoners, 1,823 students preparing to join higher institutions of learning, and 15,879 low-level administrative officials attended Ingando. Every year at least 1,500 attend such solidarity camps.
Gacaca courts were initiated in Rwanda as a traditional means of settling disputes among communities. In post-genocide Rwanda, formal courts were not equipped to adjudicate all genocide cases that were pending. Also, the number of genocide suspects was so large that the courts would have taken a hundred years to try them. There were a limited number of qualified judges, inadequate equipment, and limited space and buildings. The gacaca courts, though a homegrown concept, worked within the framework of Organic Law no. 08/96 of August 30, 1996. The latter elaborated on legal proceedings in cases of infringements that constitute a crime against humanity. A landmark of the law was separating genocide crimes in Rwanda into four categories.

The first category includes planners, organizers, instigators, and supervisors of the genocide. The second consists of authors, co-authors, and accomplices of deliberate homicides or of serious attacks that caused someone’s death. The third category is the person who committed criminal acts or became an accomplice in serious attacks without the intention of causing death. The fourth is the person having committed offenses against property.

Under the law, only 6,000 of 120,000 detainees were tried in approximately five years. At that rate, it would take more than one hundred years to try these detainees. It is important to note that justice also concerned the suspects who were still among the communities in exile, but who could not be arrested due to lack of space in the existing prisons, extradition problems, and prosecution facilities. Gacaca was introduced as an alternative solution to the backlog of trials and procedures.

Gacaca courts constitute a system of participative justice whereby citizens are given the chance to speak out against those who committed atrocities and to judge and punish the perpetrators with the exception of those classified by the law in the first category, who will be judged and punished by the ordinary courts according to common-law rules. This system enables ordinary citizens to speak about what happened during the period of genocide. It also enables them to give testimony in public. The kind of justice carried out in the context of the Gacaca courts allows people to sit in cells, sectors, districts, and provinces and is composed of men and women of integrity elected by their neighbors.

As a participative mode of administering justice, Gacaca has met multiple purposes that have characterized post-conflict governance. It has served as a method of revealing what actually happened during the genocide. This has been accomplished via a simple method of compiling lists of victims and the perpetrators of the atrocities. It has obviously expedited the genocide trials. About 11,000 Gacaca courts have shared the work that was originally planned to be done by 12 specialized courts.

Other functions of these courts have been to support the effort of abolishing a culture of impunity in Rwanda, to reconcile Rwandans and reinforce unity, and to use a traditional approach to justice as a modern way of enabling Rwandans to address their own problems. Despite earlier skepticism with regard to their capacity and competence, the Gacaca courts can be regarded as having fulfilled a successful participatory process after the backlog of genocide cases have been cleared.

Large numbers of genocide survivors and witnesses have participated in the process. Notable among these has been the role of women. Religious, administrative authorities and civil

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145 In vernacular, gacaca is soft grass on which elderly people sat and resolved community conflicts consensually. It has been developed into a modern concept as a hybrid of modern law and the traditional system to solve daunting genocide crimes in post-1994 Rwanda.

146 These are the current administrative units of Rwanda, arranged from the smallest to the largest.
society have greatly contributed to the process. The first verdicts led to a chain of actions and reactions, including pleas, confessions, repentances, and apologies. Most importantly, a delay of the trials would have most likely brewed more tensions and possibly conflicts. The gacaca court method of achieving justice has proved to be an innovative way of addressing a daunting post-conflict problem in a participatory manner.

Ubudehe

Ubudehe is another Rwandan innovation drawn from traditional practices of collective and mutual help to create a post-conflict process of creating social capital and active citizenship. It was initiated by the government as a pilot program in 2001 that was part of a participatory poverty assessment. Over the years, it has been utilized throughout the countryside not only as a poverty reducing initiative, but also as a bottom-up approach to reconstruction in Rwanda. At present, it has been institutionalized as part and parcel of the decentralization policy.

There are 15,000 villages, up from 9,000, in the system wherein communities analyze, define, and map their own poverty conditions. They further identify who is poor in their communities and classify the poor according to traditional ways of defining need. The communities then decide how to use more prudently a government grant, which has typically been up to Euros 1,000. The Ubudehe method has become another useful post-conflict tool, conceived from traditional values blended with modern poverty reduction policies, which applies participatory methods in a framework of decentralized administrative structures. The information generated from social maps is now being used to act as performance measures to hold the national government and relevant ministries accountable to live up to the commitments they have made.

Another major achievement of Ubudehe is the fact that citizens not only identify and state their preferences and poverty characteristics, but also have the opportunity to come together in collective action to address high-priority problems they have reported. With Ubudehe, it has been possible to restock livestock lost during the genocide and to provide public goods, such as primary health care or water, in collaboration with the government. Evaluation and periodic assessments have noted remarkable successes in bringing communities together and fighting the most abysmal levels of poverty, such as basic food security.

POST-CONFLICT ECONOMIC AGENDA

Dimensions of Rwandan conflict and recovery

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147 The literal origins of the word *ubudehe* describe the practice of digging fields before the rains come and the planting season arrives. A group of households join together to dig their fields, acting collectively to share the burden of the work and make sure that everyone is ready in time for the planting season. The concept of *ubudehe* is inclusive, covering men and women and all social groups, including the Twa minority ethnic group. It can also be extended to those who are too poor or incapacitated. The word *ubudehe* was selected to present a quick mental image of people working in collective action to solve problems of local people, by local people, for local people with support from local governments, NGOs, local resource people, and donors. It sets out to strengthen democratic processes and governance starting from the people’s aspirations, abilities, and traditions.

148 For more on Ubudehe, see, for example, OSSREA (2007); and Butare, survey for input into EDPRS.
There are multiple variables of the economics of the Rwandan conflict.\textsuperscript{149} Stewart (2006) identifies the variables that are most directly affected by conflict as food security, exports, imports, inflation, tax revenue, government expenditure, and budgets. Studying government expenditures can reveal how expenditures on social and economic services and on the military respond to conflict. Budgets are also affected in relation to domestic resource mobilization, aid, debt management, and foreign capital. All of these types of outlays affect entitlement and human development. The rest of this section provides data that complements earlier descriptions of the effects of genocide on Rwanda’s population and the country’s resources.

Between 1990 and 1993, the government’s expenditure patterns changed in order to finance the civil war. The army had expanded from 5,000 to 40,000 soldiers in the period. Major external aid was diverted from structural adjustment particularly financing poverty reduction to fund the government’s efforts to defend itself during the civil war. It is estimated that Rwanda received the equivalent of a total of US$260 million from all external sources (Storey 1999). Most of these funds were directed to funding the war.

Between 1991 and 1994, the Rwandan government purchased machetes, pick axes, sickles, and other equipment (used later in the genocide) for about US$4 million (the equivalent of RWF 640,338,414), using funding from other countries. Monies spent on weapons and ammunition amounted to more than US$83 million. It is estimated that the war cost the government up to $100 million per year. Before 1990, regular military expenditures accounted for 14 percent of Rwanda’s national income. They accounted for 37 percent in 1990, and 51 percent of total state income. In 1991, military expenditure was equivalent to 71 percent of total expenditure on goods and services (Chossudovsky and Galand 1995).

The country’s GDP fell by approximately 50 percent or an estimated US$500 million in 2002.\textsuperscript{150} The fall was equivalent to 15 percentage points on the head count poverty index or one-fourth of observed poverty. The absolute cost of the conflict is estimated to have been equivalent to raising the gross national income (GNI) per capita from US$230 to US$290. Estimates show that if the genocide had not occurred, per capita income would have been more than 30 percent higher in the post-conflict period.\textsuperscript{151}

Despite the immense costs of conflict, Rwanda has generally recovered in the last 15 years. A comparison of GDP trends before and after the conflict indicates that the economic recovery has been remarkable. In fact, with the average rate of GDP growth being more than 6 percent, Rwanda has enjoyed one of the best growth rates of any country in sub-Saharan Africa.


\textsuperscript{150} This is a very sharp decline. It is usually estimated that in short wars the fall could be about 2 percent of GDP. But note that the Rwandan civil war culminated in genocide, causing much of the population to flee.

\textsuperscript{151} The World Bank (2003) compares actual and predicted trends of GDP per capita with or without genocide in Rwanda.
The main questions are the following: What accounts for Rwanda’s dramatic recovery? What roles did policy and foreign assistance play in a context of tradeoffs and competing priorities? These issues, above all, need to be addressed for sustainable peace building.

Policy reform and poverty reduction

The post-conflict period in Rwanda can be divided into three phases consistent with economic policy and poverty reduction. The period between 1995 and 1999 was referred to generally as the emergency period. From 2000 to 2005, there was significant reconstruction and recovery, and since 2005, Rwanda has generally entered a development phase. These categories are important in post-conflict discourse for a number of reasons. It is important to know which priorities to put forward at what time. In the emergency period, the emphasis was on humanitarian support, looking after displaced persons, and fostering the returning peace more generally. In that context, we look at the government’s budget and donor support. The next phase has been known in Rwanda as that of building infrastructure, including schools, and restoring the economy to pre-genocide times. In the current phase, Rwanda is faced with problems similar to those of any other developing country.
In this subsection, we focus on the more general policy events in post-conflict Rwanda; the next subsection discusses the fiscal, monetary, and trade policies during the same period. Aid is considered more specifically in the subsequent section.

In response to the emergency, the GoR received assistance through an International Development Association (IDA) economic recovery credit and International Monetary Fund (IMF) post-conflict assistance. Multilateral and bilateral aid was given to cover emergency assistance and rehabilitation. It is noteworthy that Rwanda’s economy also had structural problems that needed to be addressed. One feature of aid to Rwanda is that support was not designated as narrow emergency support only. The government had shown its commitment to work toward a liberal, market-based, minimum state intervention policy by December 1994; these key principles defined and guided its economic policy. The new policy supported the liberalization of trade and exchange rates, the privatization of state parastatals, and a reduction in military expenditure.

In March 1995, the GoR launched reform efforts by liberalizing trade and exchange regimes. The exchange rate system was liberalized; the export surrender requirement was abolished in 1997, the central bank was rehabilitated, indirect monetary policy instruments were introduced, and the trade system was reformed with substantial reductions in tariffs (IMF 2004a). Rwanda produced a Policy Framework Paper (PFP), under the auspices of the World Bank and the IMF, which guided policy reforms from 1998 to 1999. In June 1998, the Government adopted an economic reform program elaborated in the first post-genocide policy framework paper (PFP), prepared in collaboration with the staffs of the World Bank and the IMF. The program received strong support from multilateral institutions and some bilateral donors. Under the IMF’s new condition to qualify for status as a Poverty Reduction Growth Facility (PRGF), Rwanda wrote a Poverty Reduction Strategy Paper (PRSP) instead of a PFP, as it had done before. Rwanda became one of the first 77 countries to submit a PRSP. In June 2000, a National Poverty Reduction Program was set up in Rwanda. The first task of the program was to draw up an Interim PRSP, which was presented to the donor community and approved by the Bretton Woods Institutions (BWIs), that is, by the World Bank and the IMF, by the end of the same year. While Rwanda became eligible for highly indebted poor countries (HIPC) support in 2000, after a successful policy reform the actual reconstruction can be identified with the first PRSP that was passed in 2002 and lasted three years until 2005.

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Rwanda started to be subject to constant supervision and reviews in order to access the Poverty Reduction and Growth Facility (PRGF) program funds that had replaced the Enhanced Structural Adjustment Facility (ESAF). As provided in the HIPC conditionality, the first annual review was carried out in June 2003, and a second was completed in June 2004. In May 2005, Rwanda qualified for debt relief after reaching the completion point. This is the same year Rwanda completed its first PRSP.

In 2006, Rwanda started drawing up a second PRSP, referred to as the Economic Development and Poverty Reduction Strategy (EDPRS), following the World Bank’s framework. This EDPRS, completed in 2007, projects the country’s needs from 2008 through 2012 and formulates its second medium-term strategy toward attainment of the long-term

<table>
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<tr>
<th>Box 1. Policy and structural reforms</th>
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<tr>
<td><strong>Overview of Policy and Structural Change</strong></td>
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<tr>
<td><strong>Money and Banking</strong></td>
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<tr>
<td>1997: New central bank law adopted</td>
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<td>2001: Introduction of weekly foreign exchange auctions</td>
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<td>2002: Full audits of three commercial banks</td>
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<td>2002: First external audits of the NBR</td>
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<td><strong>Exchange and Trade Relations</strong></td>
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<td>1995-99: Reduction in maximum tariff rate from 100% to 25%</td>
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<tr>
<td>1997: Export surrender requirement eliminated</td>
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<td>1998: Article VIII accepted</td>
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<td>1999: Export taxes eliminated; ETBs removed</td>
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<tr>
<td>2002: 80% reciprocal reduction in COMESA import tariffs</td>
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<td>2004: Entry into COMESA FTA</td>
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<td><strong>Fiscal Policy and Management</strong></td>
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<td>1997: Revised direct tax code introduced</td>
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<td>1997: Rwanda Revenue Authority established</td>
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<td>1998: Establishment of the Office of the Auditor General</td>
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<td>2000: Computerized tax data management (ASYCUDA) introduced</td>
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<td>2001: VAT introduced</td>
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<td>2002: Tax Code revised</td>
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<td>2004: Organic Budget Law approved</td>
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<td><strong>Privatization</strong></td>
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<td>1998: Sale of PetroRwanda assets</td>
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<td>2000: Establishment of Private Sector Federation</td>
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<td>2001: Liberalization of telecommunications Sector</td>
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<td>2003: Private management of electric utility</td>
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<td>2004: Sale of BCR, BACAR</td>
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<tr>
<td><strong>Other</strong></td>
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<tr>
<td>1998: Demobilization and reintegration program begins</td>
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<td>1999: Adoption of Rwanda Investment Promotion Act</td>
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<td>2000: Adoption of Revised Internal Trade Act</td>
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<td>2002: Establishment of Public Utilities Regulatory Agency</td>
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<td>2003: Adoption of new constitution</td>
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Source: IMF 2004, 04/382
Rwanda Vision 2020 objectives. Meanwhile, by the end of 2006, the government had released the Second Household Living Conditions Survey and a poverty update. Poverty was observed to have gone down by more than 3 percentage points on the Head Count Index since 2002. As the data below shows, this was a long way from the poverty levels of the period immediately after the genocide.

The EDPRS cited a number of basic principles that it called pillars. These are economic growth, macroeconomic stability, and prioritization of public actions, which work together to forge a sound partnership between government and other stakeholders and human resource development. Priority sectors were agriculture (for transformation of the rural areas), human resource development, economic infrastructure, good governance, private sector, and a number of cross-cutting sectors, particularly, technology, gender issues, environment, HIV/AIDS, capacity building, villagization (imidugudu), and the reduction of inequality.

More tangible targets are even more informative. In terms of government expenditure, the main beneficiaries are education (19.8 percent of the total budget), health (9.2 percent), transport and information communication technology (ICT) (7.2 percent), agriculture (6.9 percent), energy (6.1 percent), and water and sanitation (4.3 percent). The annual GDP growth rate is planned to rise from 6.5 percent to 8.1 percent by 2012. Export growth is scheduled to increase at 15 percent per annum compared to its current rate of 10 percent. This accelerated pace of growth will be made possible through a large increase in the investment rate, which will rise from 15 percent of GDP to 23 percent by 2012. Overall, Rwanda has been on track with an annual average growth rate of GDP over 6 percent and reaching double digits of 11 percent in 2008. The Vision is generally regarded as on track, since per capita income reached US$500 in 2010 more than half of the target amount of US$900 ten years down the Vision.

Throughout the three phases, there was substantial growth in the economy. Some experts say that the Rwandan post-conflict transition of the past 15 years was a catching-up or bouncing-back phenomenon, and others assert that poverty reduction policy had an effective impact on the recovery process. It is noteworthy from Coulibaly’s 2007 account and the list of Rwanda’s reforms that policy reforms were not narrowly confined to emergencies but were subject to broad policy reform through the PRSP, which addressed forward-looking developmental challenges. In this regard, it can be asserted that part of post-conflict recovery was a ‘catching-up’ effect as a result of peace, but the country’s performance in the developmental phase of its recovery is probably more related to policy reforms.

In general, poverty in Rwanda has declined. In 1995, absolute poverty was recorded at its historically worst: 78 percent of the population (that is, those who had not fled the country) was existing on the one dollar per day poverty line. On the eve of the Poverty Reduction Strategy paper’s publication in 2002, it was estimated that 62 percent of the population were living above the national poverty line, with incomes of about Rwf 63,000 per adult per year. By the end of the recovery period in 2005, poverty had gone down to 59.2 percent living above the national

156  The goals of EDPRS reflect the general argument that Rwanda is now in a phase where more developmental challenges are driving and binding economic policy.
157  A study using econometric modeling by Coulibaly’s et al. (2007) shows that policy has had a substantial effect on total factor productivity. One case is the emphasis on human resources. The World Bank (2003) study shows the catch-up effect on GDP per capita in Rwanda but does not dismiss the impact of policy making.
poverty line, which had been adjusted to Rwf 90,000 per adult per year. Given the country’s
ostensible recovery and growth, many wonder why poverty was not reduced more tangibly.

Growth and redistribution are competing priorities if the former does not result in
proportionate reduction in poverty levels. Thus, the question of poverty reduction has been a
debate on whether Rwanda’s first-generation PRSP was sufficiently pro-poor. In spite of the
country’s tremendous growth in the past 15 years, the Gini coefficient rose to more than 0.5
by 2006 from less than 0.4 in 2000. A post-conflict recovery in economic terms is important, but
there has to be recognition of related matters, such as income distribution and pro-poor growth.

Fiscal and monetary policy

Fiscal policies and regimes are crucial to post-conflict transitions in various ways. These are
through tax revenue collection, government spending, and budget deficits. The patterns of
government expenditure are in relation to the relative prioritization of social services, economic
activities, and the military. Under Rwanda’s monetary policy, two major issues are (1) how
monetary policy has been used to manage inflation after the genocide and (2) the choice between
a rather tight monetary policy with inflation targeting and a more expansionary policy.
Historically, domestic revenue mobilization has been low in Rwanda. Fiscal performance
generally improved in the post-conflict setting. From 1994 to 2004, revenue collection as a
percentage of GDP grew from 3.6 percent to 13.9 percent. The narrow tax base is partially
explained by the small formal sector engaged in market production, but it is also true that
collection still needs to be more efficient. It is usually argued that increased revenue collection
was due to the various institutional and policy reforms in the post genocide period (see Box 2).

158 There is a general and common sense understanding that poverty has declined significantly compared to the
period after the genocide, the comparability of the variant poverty lines used notwithstanding.
159 Gini coefficient is an economic measure of inequality usually between 0 and 1. Countries whose coefficient is
above 0.5 are regarded to have a skewed income distribution and a high degree of inequality between those with low
incomes and those with high incomes.
The fiscal balance, which had been at -8.4, declined to -0.1 in 1997 and then surged up to -5.3 in 2004. This means the balance between revenue and expenditure improved positively as the expenditure overruns revenue collection grew faster than expenditure. From 2001 to 2006, revenue collection grew to around 13 percent of GDP. The domestic fiscal deficit, however, widened from around 2 percent of GDP in 2001 to 6 percent in 2006. Aid has been instrumental in covering the fiscal gap. A noteworthy challenge is that even the government has concluded that over-dependency on aid in post-conflict phases is not healthy. Aid is important for a country’s ability to recover from conflict, but a country’s own resource mobilization and reduction of dependency on outside aid are also desirable.

An issue related to Rwanda’s fiscal regime has been the debate between narrow fiscal policies as opposed to an expansionary fiscal policy. Under the IMF’s policy regulation, Rwanda has been told to keep its budget deficit at a minimum. The IMF’s PRGF document of August 2004 indicates the target of domestic fiscal deficit at 5.6 percent of GDP and the target of domestic revenue at 13.5 percent of GDP (IMF 2004b). Fiscal policy focuses on strengthening revenue administration and expenditure management.

Proponents of expansionary fiscal policies argue from the point of view of a low output base and the possibility of larger deficits arising from a need to bolster public investment for poverty reduction. The latter argument would, however, need qualification of which major types of investment caused the larger deficits. Tangible poverty reduction deficits would have to be matched with larger investments that are geared to improve, for example, infrastructure in the rural areas or roads to unlock the productive capacities of the rural areas. So far, the tendency in Rwanda has been restrictive with a keen interest in keeping good books that will be approved by international financial institutions (IFIs), especially the IMF.

Sources: GoR (2007)

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160 National Institute of Statistics Rwanda (NISR) GDP estimates.
161 Revenue excluding grants minus current expenditure, domestically financed capital expenditure, and net lending, excluding external interest, according to IMF (2007) MEFP Tables.
Another important issue under fiscal policy in a post-conflict setting is how expenditure is apportioned among different sectors. The sectoral allocation of public expenditures within the recurrent budget reveals that overall interest payments on public debt, economic services, and general public services have been increasing. The trends for defense and social service spending initially had an inverse relationship; from 1999 to 2001, defense spending decreased from 31 to 23 percent of total recurrent expenditures, and as social service spending rose, from 25 to 29 percent of total recurrent expenditures. In 2002, an interesting reversal occurred when defense spending increased substantially, to 27 percent of total recurrent expenditures, and social service spending decreased to 18 percent of total recurrent expenditures. In 2003, this trend was again reversed, with defense spending declining to 15 percent of total recurrent expenditures and social service spending increasing to 25 percent of total recurrent expenditures. Military spending deserves to be a study on its own in a post-conflict transition. In Rwanda, a series of insurgencies and counter insurgencies occurred in 1997, 1998, and in early 2000. Despite the swings in military expenditure mentioned above, however, we do not see a consistently rising amount of military expenditure versus social services in Rwanda. The main reason for this has been that Rwanda has had to keep military expenditures low as a condition for receiving aid, as set forth by the World Bank and the IMF.

Social service spending as a proportion of total recurrent spending in 2003 did not recover to 2001 levels. As of 2010, Rwanda has increased its social spending and its allocations to health and education in the recurrent budget are regarded as among the best in Africa. This is partly because of the squeeze on spending precipitated by higher interest payments on public debt. The latter in the context of fiscal policy means a trade-off between social spending for poverty reduction and the need to meet other obligations, such as debt repayment and a narrower fiscal policy stance.

Monetary policy is important in post-conflict reconstruction because inflation is likely to increase as a result of conflict. Although some economists attribute inflationary pressure to structural problems in Rwanda in the early 1990s, it is also common knowledge that diversion of expenditure to military goods results in scarcity of other goods, which easily creates inflationary pressure.

In 1997, a new central bank law was directed to empower the National Bank of Rwanda. Two commercial banks were privatized, and weekly foreign exchange rates were introduced. But over the post-genocide period, the financial sector continued to be plagued by non-performing loans, with allocation of credit to commerce and construction and low absorption of credit by the agricultural sector, which is the mainstay of the economy of Rwanda. Loans to urban dwellers increased tenfold.

During the first poverty reduction strategy from 2002 to 2005, the inflation target was set between 3.5 percent and 6.5 percent. This was consistent with the conditionality in the PRGF which called for an inflation target of 5 percent. Two points need to be made here. Historically, Rwanda has had low to moderate inflation. And inflation in Rwanda seems primarily driven by supply factors. Inflation averaged 12.5 percent in the 1970s and dropped to 4.7 percent on average through the decade of the 1980s. In the 1990s, except for the year 1994, Rwanda’s inflation was exceptionally low, in comparison with other conflict-prone countries, at 15.1 percent. The peak was above 50 percent in 1994 and then dropped to 41 percent in 1995 and to 7.4 percent in 1996. But inflation went up to an average of 12 percent by the end of 1996, owing mainly to food price increases. This time the pressures arose from demand arising from the return of refugees, as well as by security problems in some food-producing regions.
From 1999 to 2003, inflation averaged 2.85 percent. In 2003, inflation rose to 6.9 percent mainly due to supply shocks, arising from poor weather conditions and rising oil prices. But in recent years except for 2009 and 2010, inflation has remained a single digit number. It was 7.5 per cent in 2004, 8 in 2006, 9.1 in 2008 and 15.4 per cent in 2009 and was estimated to be 10.4 in 2010 (CIA Fact book 2010).

An area of debate in Rwanda has been a need for the IMF to recommend tight monetary control with inflation targeting. With a target of 5 percent inflation per annum, Rwanda managed until 2005 within the phases of post-conflict reconstruction to exercise a tight monetary policy. Whether this has been responsible for poverty reduction is not easy to establish directly, but low inflation is important for macroeconomic stability, which is an important factor for poverty reduction.163

A second area of debate is what drives inflation in Rwanda. In post-conflict Rwanda from August 1994, the Central Bank controlled strictly the money supply as one step toward containing inflation, along with open-market operations, setting interest rates, and regulating the financial sector. In the period immediately after the genocide, the most serious economic problems were the lack of financial institutions, a weak financial sector, and unreliable links among the money base, money multipliers, and monetary transmission mechanisms. Factors that made controlling the money supply problematic included demand pull or inflation arising relative scarcity of good and imported inflation. During that time, the causes of inflation were not as much from the supply side of money as from external conditions based on relations with other countries and vagaries of the economy following numerous disruptions caused by the conflict.

Currently in 2010, while financial depth in Rwanda compares favorably with other Sub-Saharan African countries with similar levels of income, it remains low by worldwide standards. The average level of broad money (meaning currencies such as notes and coins plus other tools like checks and transfers) to GDP stood at 18.5 percent in 2003. Many of the recent increases in monetization have been due to the growth in foreign currency deposits, which account for about one-third of all deposits.

Crucially, Rwanda’s formal financial system is highly concentrated, both in terms of geography and sector. There is little formal credit availability outside of Kigali, and only 7 percent of the population has bank accounts. According to the IMF, commercial banks compete for a core group of about 50 large corporate customers and a customer base of about 100,000 individuals and 10,000 corporate customers. At the end of June 2004, the banking sector consisted of the Central Bank, the Banque Nationale du Rwanda (Rwanda National Bank, NBR), six commercial banks, and three special-purpose banks. Today there are about 10 commercial banks including at least branches of foreign and banks and scores of microcredit institutions.

Government involvement in the banking sector in the past has been significant but diminished after privatization of several banks in the late 1990s. The sector was largely liberalized in 1995, with de-licensing and the elimination of most restrictions on interest rates. Nevertheless, the banking sector is not competitive in its structure, with the three largest commercial banks accounting for two-thirds of deposits and nearly two-thirds of outstanding loans (IMF, 2004b). Non-performing loans represent a large burden to the banks with about 30 percent of gross loans classified as non-performing as of 2003. With drastic reforms in the financial sector, the problem of nonperforming loans has largely been addressed.

163 The poor are most likely to be hit the hardest when inflation rises.
A major lesson that Rwanda has learned from the post-conflict transition is that none of the strategies undertaken to control inflation worked very well. However, the country’s leadership in every sector has demonstrated the will to undergo reforms, exercise financial discipline, and build institutions—all of which are known to lead to macro-stability.

**Aid in post-conflict Rwanda**

Before 1994, during a period of crisis in 1980s, foreign aid was generally available from donors because Rwanda was regarded as a good performer. This does not contradict what was stated earlier regarding declining GDP, agricultural productivity, sporadic famine and malnutrition in early 1990s, and increased military spending between 1990 and 1994. There is limited but true evidence that Rwanda’s conflict machine was indirectly oiled by development assistance.\(^{164}\) We noted before how support from the World Bank was used to finance a war instead of structural adjustment program. But more data and figures have not yet been generated to show the link between aid and the conflict in Rwanda. Only Uvin (1999) has tried to show how development may have aided violence in Rwanda. But except for aid disbursements between 1990 and 1993, there is no data yet that aid and genocide went hand in hand. What is important is that aid should not have been used to assist in arming rebel groups or to fuel tension between opposing factions.

In Rwanda’s post-genocide period, as in most post-conflict states, aid increased tremendously immediately after the emergency and declined later. The importance of aid and policy reform in post-conflict transitions cannot be overstated.\(^{165}\) Rwanda has received a substantial amount of aid. In the period between 2000 and 2007, the net overseas development assistance (ODA) as a percentage of GNI was above 20 percent and was averaging around 27 percent as of 2003. This is a great improvement compared with 1994, when ODA was over 94 percent of GNI and declined to 54 percent in 1995. From 1997 to 1999 it fell below 20 percent.

It has been estimated that Rwanda currently receives aid from other countries equivalent to US$55 per capita per year. According to Rwanda’s Economic Development and Poverty Reduction Strategy (EDPRS) estimates, however, the country requires about US$140 per capita per year in order to challenge poverty significantly, that is, another $85 per capita per year. In addition, to scale up investment and ensure that millennium development goals (MDGs) are achieved, Rwanda would need an additional US$10–24 per capita per annum.

The issue, however, as we argue below, is not only quantity but also quality. For instance, at the rate of poverty in 2006 of slightly more than 57 percent of the population living below the poverty line (that is, on less than US$1 per day), the levels of aid provided at that time—*if exclusively given to the poor*—would double their incomes in one year. That is about US$100 per person. In other words, the opportunity cost of using aid for poverty reduction is higher than the 2006 expenditure. In policy terms, it is sensible to argue that poverty could have been better targeted in the last 10 years if a larger amount of aid found its way to the poor.\(^{166}\)

\(^{164}\) Uvin (1999), *Aiding Violence*.

\(^{165}\) Collier and Hoeffler (2002b), in “Aid, Policy, and Peace,” note that aid and growth minimize risk, aid is enhanced by policy reforms, and policy reforms are by aid. Major risks include income distribution and dependency on primary products.

\(^{166}\) See GoR(2002) and GoR(2005) on Public Expenditure Tracking Surveys (PETS). PETS financed by the World Bank found that little money reached the beneficiaries in the education and other services sector. The findings influenced policies that were drawn up later under the EDPRS. For instance, capitation grants were initiated to ensure funds reached needy primary schools more effectively.
A related issue is that in a post-conflict context, aid has been useful for reconstruction and as a result has tended to benefit governance and sectors that are related to reconciliation in Rwanda. In post-conflict discourse, the most important inquiry is the role of aid. It has been noted that more aid is necessary in post-conflict situations. However, “frontloading” can be detrimental to long-term development by crowding out revenue collection and domestic mobilization of resources. Normally, less aid is available when it is most needed for long-term and sustainable development. Given the trends on aid to Rwanda, larger amounts of aid were given during emergency periods. However, 13 years after the conflict, in 2007, foreign aid had no significant effect on revenue collection and, perhaps to a certain extent, no effect on domestic resource mobilization.

A final important point is that not all aid pledged in a post-conflict situation is always given. Although it is usually assumed that large amounts of aid are given to countries after conflicts, it is important to assess how much effectively reaches the concerned countries. In summary, the challenges that Rwanda has faced in relation to development assistance in a post-conflict context are like most post-conflict situations and include the following:

a) Resources are directed to key policies that are not always significantly related to risk mitigation.
b) Donors have different interpretations of how Rwanda should conduct its post-conflict business and, thus, differ on quantities and types of aid.
c) Dependency on aid is still high.
d) Under the Paris Declaration framework, aid given to a particular budget is considered more effective than aid to particular projects and could be regarded as an implicit answer to the foregoing discussion. However, more studies on aid effectiveness are still needed.
e) Security in the Great Lakes region, which includes Rwanda, Burundi, and the DRC, has often been tied to aid to Rwanda.

LESSONS FOR PEACE AND DEVELOPMENT

a) Power-sharing models may not deliver before a conflict as expected, but they can still be useful in post-conflict transitions. The Arusha Agreement has been used as a Power-sharing Model for Rwanda. The agreement broke down, and what ensued was a human catastrophe unprecedented in the last century. The Rwanda genocide presents a case where standard power-sharing mechanisms have not worked. Power sharing in Rwanda through the Arusha Accord was subject to endogenous and exogenous factors. While the principal players were the government of Rwanda and the RPF, the power-sharing process was influenced by regional leaders and the international community. The birth of many parties and the development of radical groups put immense pressure on the leaders who were tasked with implementing the agreement. The breakdown of the peace process could hardly be attributed to the two parties alone. During the transition, the elements of the power-sharing model in the agreement were used. The principles enshrined in the Arusha Peace Accord were used in the transitional Broad-Based Government between 1994 and 2003. The Forum followed principles enshrined in the Arusha Accord although in a different post-conflict context. It should also be noted that the Arusha Accord called not only for rule of law and democratization but also for accountability and good
governance, tenets that have been high on the post-conflict reform process agenda of Rwanda.

b) Post-conflict efforts should not focus only on emergencies and rehabilitation. Development goals with risk-mitigating policies need to be kept in sight. The idea that a country that has experienced conflict is likely to fall into conflict again is a fair judgment. That is why mitigation is important. Rwanda has shown that however large its emergency and rehabilitation needs were and continue to be, leaders and citizens also need to stay focused on the longer term and the larger picture of development. This is possible if those providing aid support are also attuned to the same policy goals. The conclusion is clear from the discussions of policy reforms that were taken by the government of Rwanda as early as 1996.

c) Aid can be made less harmful to the post-conflict economy if fiscal and monetary policy measures are taken early at the beginning of the transition. The discussion on narrow versus expansionary monetary policies in Rwanda corroborates this conclusion. Aid is good for post-conflict transition. It can be harmful if it is used to aid violence. It can also be harmful if it crowds out domestic resource mobilization. It was noted how Rwanda has enhanced aid by putting in place institutions for fiscal austerity.

d) Poverty reduction should also be given priority as risk mitigation. The link between poverty and conflict may not be clear in the context of this paper but it is a stylized fact that countries with lower per capita incomes have been more vulnerable to conflict. It is important that poverty reduction be given a front seat in the post-conflict transition. Rwanda has gone through a rigorous poverty reduction strategy through PRSP and EDPRS with related policy reforms. Poverty reduction efforts should include more pro-poor policies and should take into account the need to reduce inequality as economic gains are recorded. In the case of Rwanda we noted that poverty could have declined by a bigger rate given the considerable growth of the economy.

e) Economic and political strategies must be linked in order to prevent possible recurrences of conflict related to poverty and economic stagnation. The Rwanda case has shown how conflict is a function of politics as well as economics. Good governance, decentralization, and economic policy must be robust and well balanced. Rwanda presents such an attempt.

f) Innovations in managing post-conflict transitions are possible. Rwanda has tried homegrown practices to face the most intricate post-conflict economic, political, legal, and social challenges: *Ubudehe* has been used for poverty reduction and creating social capital; *Gacaca* for encouraging free speech and participation in genocide courts; and *Ingando* to bring about reconciliation, social recapitalization, and active citizenship. Although these practices look Rwandan in content, they are, in fact, a blend of traditional and modern methods and practices quite familiar to Rwandan citizens.

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Political and Economic Policy Priorities in Supporting Post-Conflict Peace and Development in Sri Lanka

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INTRODUCTION

On May 19, 2009, the civil war between the Liberation Tigers of Tamil Eelam (LTTE) and the government of Sri Lanka, which had ravaged the country for 26 years, came to an end with the defeat of the LTTE. The military conclusion to the conflict came about after several failed attempts at power sharing between Tamil groups and the central government. However, the end of the war does not guarantee sustainable peace in the country because the war was a violent manifestation of deeper political tensions between the two major ethnic groups—the Sinhalese and the Tamils. Therefore, the need for a broader political solution to the ethnic issue in Sri Lanka remains.

In this chapter, we explore the prospects for power sharing in post-war Sri Lanka by drawing on past experiments in power sharing in the country. Section 1 explores the causes of the conflict in Sri Lanka, particularly referring to post-independence policies that promoted majoritarianism (such as the citizenship act and discriminatory policies regarding language and higher education) to gain political advantage and the role of economic policy failure in creating an environment conducive to armed conflict, along with a high degree of youth unemployment and economic stagnation. In section 2, the efforts by subsequent governments to address minority grievances are examined. From this section, we conclude that devolution of power has remained the country’s most problematic, divisive issue.

Section 3 of the chapter looks at the failures of previous attempts at power sharing including the Indo-Lanka Accord and the failure of an externally driven power-sharing mechanism, the Provincial Council (PC) system, which had little domestic political support and was not based on socioeconomic conditions in Sri Lanka. The weaknesses in the PC system have eroded political support for devolution of power in Sri Lanka. Opposition to power-sharing agreements by opposition political parties and the lack of political stability among ruling parties have made it almost impossible for governments to negotiate compromises with minority groups. In the past, an enormous stumbling block that hindered peace efforts through power sharing was the increasing prominence of the LTTE, which resulted in the militarization of political issues, exacerbated by terrorism. As the LTTE is effectively out of the picture now, the prospects for a sustainable political solution are far greater. In Section 4 we examine in further detail the various peace processes after the Indo-Lanka Accord and the proposed alternative power sharing systems. Once again, the lack of Southern political consensus dominated the failure of many of these processes. Section 5 explores the prospects for post-conflict sustainable development with an emphasis on the required economic policy reforms that could support a sustainable peace in Sri Lanka. In section 6 we the case that rhetoric on power sharing now needs to manifest at the policy implementation level for there to be a lasting peace.

167 The views expressed in this paper are those of the authors and do not necessarily reflect the positions of any institutions they are affiliated with.
Post war trends and policy options

The post-conflict era creates numerous economic opportunities but nonetheless, important political challenges remain. We examine these in section 6, particularly relating to the lack of effective Tamil political representation to articulate the political aspirations of the Tamil polity. The politicization and ethnic dimensions affecting devolution of power have hidden the potential benefits of devolution from an economic and governance perspective. As a result, much of the opposition to devolution is based on issues such as the validity of the “traditional homelands” theory and the fact that half of the Tamil population live outside the Northern and Eastern provinces. However, the issue of devolution (as power sharing) has been lost in this rhetoric. An effectively implemented system of devolution between Tamils and Sinhalese is bound to reap benefits for the entire Sri Lankan populace by bringing about economic advantages and superior governance structures. A key challenge will be to ensure that a future power-sharing arrangement will not repeat the mistakes of the existing Provincial Council structure, which has caused tremendous economic inefficiencies and poor service delivery. As we examine these issues, we argue that a new, effective system of power sharing, based on devolution of power, will go a long way toward ensuring sustainable peace and development in Sri Lanka.

POLITICAL ROOTS OF SRI LANKA’S ETHNIC CONFLICT

Sri Lanka is a multiethnic, multireligious society. The Sinhalese make up the majority (74 percent) of the population; and speak the Sinhalese language. The Tamils are the largest minority (12.6 percent) of the population and speak the Tamil language. There are two distinct Tamil communities in Sri Lanka. The Sri Lankan Tamils make up the majority of the populace of the Northern Province and parts of the Eastern Province. The Indian Tamils were brought to Sri Lanka by the British in the nineteenth century to work on tea plantations in the hill country of the Central Province. By 2010, the majority of the country’s total Tamil population, descendants of both groups, lives outside the North and the East of the country, with a large percentage of Tamils living in the Western Province. Even though it is a religious designation, the census names Muslims (7.1 percent) as the third substantial group in Sri Lanka, most of whom speak Tamil. The Muslims have different ethnic and cultural backgrounds from the Tamils of Sri Lanka.

Sri Lanka has been under some form of Western influence since 1505, though the British unified Ceylon as a political entity after the fall of the Kandyan Kingdom in the nineteenth century. Before the British unified the country, its political system was fractured and decentralized, with different centers of political power held by the Sinhalese or Tamil populations or the colonizing powers. Ceylon obtained independence from Britain in 1948 under a peaceful transition of power. The following section provides an overview of some of the key post-independence milestones that have significantly influenced the evolution of civil conflict in Sri Lanka.


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169 Sri Lanka was controlled by Portuguese, Dutch, and British colonial powers.
170 Ceylon was renamed the Democratic Socialist Republic of Sri Lanka in 1972.
The Citizenship Act of 1947, introduced by the first elected Parliament in Ceylon, led to the disenfranchisement of nearly 1 million Indian Tamils. The Citizenship Act, passed in 1948, contained both class-based and ethnic provisions. Members of the United National Party (UNP), in power at the time, feared that the Indian Tamils would become unionized under a communist banner and saw this as a major political threat (Oberst 1988, 179). The ethnic stipulations of the Citizenship Act resulted in the fracturing of the Tamil Congress and formation of the Federal Party (Ilankai Tamil Arasu Kadchi), under S. Chelvanayakam in 1949, who perceived the act as a manifestation of Sinhalese majoritarianism. The Federal Party (FP) advocated a federal system of government (Guruge 2006, 19). The FP’s formation was a turning point in Ceylonese politics because it identified the Tamils as being a different nation from the Sinhalese: “[T]he entire edifice of Federalist belief rested on the conviction that the Ceylon Tamils constituted a separate distinct nation” (Kearney 1967, 44, cited in Uyangoda 1994, 100). The Federal Party contested the 1952 elections on a platform of federalist policies and devolution of power, but the results were dismal, as the party secured only two seats. This was evidence of the fact that Ceylonese Tamils did not entertain ideas of federalism but chose to win their rights within the existing political framework (Guruge 2006, 19).

The Politics of Language

Political and administrative power had been shared to a great extent among the elite Sinhalese, Tamil, and Burgher171 populations during the British colonial period, largely influenced by individuals’ command of English and levels of higher education. In 1931, the Donoughmore Constitution introduced universal suffrage to Ceylon, and with increasing democratization, rural Sinhalese people found their political voice for the first time. As the Sinhalese rapidly gained political power, they demanded a reduction in privileges of English-educated citizens; this effort was led by the Swabasha movement. S.W.R.D Bandaranaike was the first politician in post-independence Ceylon to exploit the surge in Sinhalese nationalism. His party, the Sri Lanka Freedom Party (SLFP), came to power through a coalition in the 1956 general election on a platform of making Sinhalese the official language of the country. Bandaranaike had initially envisaged a policy of bilingualism (Sinhalese and Tamil) as a viable alternative to the English language; however, as Sinhalese activists opposed bilingualism, it was dropped in favor of “Sinhala Only” in the pursuit of votes. On May 3, 1956, a parliamentary group drafted a bill to incorporate minority concerns, but this bill was also abandoned in response to Sinhalese political opposition.

The Bandaranaike-Chelvanayakam Pact: An Early Attempt at Power Sharing

Tamil opposition to the Sinhala Only Act was led by the FP; race riots occurred in 1956 when nonviolent protests against the Act were met by violence. In August 1956, the FP set out three demands: 1) autonomy for the North and East under a federal structure, 2) parity for Sinhalese and Tamil as official languages, and 3) citizenship rights for Indian Tamil plantation workers.

171 Ceylonese with Dutch and Portuguese ancestry
172 In fact, in 1944, J. R. Jayawardena (who would become prime minister in 1977 and then president of the country from 1978 until 1989) put forward a resolution to the State Council to make both Sinhalese and Tamil official languages of Sri Lanka, but his party, the United National Party (UNP), campaigned for “Sinhala Only” in 1956. (Jayawardena’s name is also spelled Jayewardene.)
Bandaranaike entered into negotiations with Chelvanayakam, the leader of the FP, and they created the Bandaranaike-Chelvanayakam Pact (called the BC Pact), which included provisions to 1) make Tamil an official language of administration in the North and East, 2) formulate regional councils to create a second tier of government by devolving power to the regions, 3) limit Sinhalese colonization for irrigation projects in the North and East, and 4) propose some amendments to the earlier Citizenship Act. The opposition UNP and the Buddhist clergy opposed the BC Pact (Wijesinha 2005, 80), claiming that any accommodation, no matter how insignificant, would eventually lead to disintegration of the unitary state (Uyangoda 1994,103). In April 1958, the BC pact was abrogated; this was followed by communal riots in May 1958.

Later that year the Tamil Language (Special Provisions) Act of 1958 came into being, incorporating some of the key provisions included in the May 1956 bill that had been abandoned. The new Act allowed Ceylon civil service applicants to take their examinations in Tamil as long as they later developed proficiency in Sinhala. It also permitted the use of Tamil in higher education and allowed correspondence with the government in Tamil. The widow of S. W. R. D. Bandaranaike, Sirimavo Bandaranaike, who was elected as prime minister in 1960, abandoned the Tamil Language Act as one of her first official actions. In 1966, when a new UNP government came into power, legislation was passed as the Tamil Language (Special Provisions) Regulations of 1966 (Oberst 1988, 182–3).

In 1972, a left-wing coalition led by Mrs. Bandaranaike’s SLFP returned to power and promulgated a new Constitution—the first Republican Constitution, which damaged the delicate balances in language politics as it made the Tamil Language (Special Provisions) Act subordinate legislation. Furthermore, it removed Section 29 of the Soulbury Constitution of 1945, which had prevented the passage of legislation that discriminated against any segment of society.

The 1972 revised version of the Constitution stated that Buddhism should have “the foremost place and it should be the duty of the state to protect and foster it” (1972 Constitution of Sri Lanka). The architect of the 1972 Constitution, Colvin R. de Silva, argued that Section 29 (2) of the Soulbury Constitution was ineffective in safeguarding minority rights (pointing to the disenfranchisement of the Indian Tamils as a case in point) and, therefore, should be replaced by a statement of fundamental rights, like those introduced in 1972.

Despite the various legislative changes to language policy since 1956, few significant changes have been made in practice. Education in the Tamil language has continued throughout the country, correspondence with the government may be written in Tamil, and public service exams may be taken in Tamil (De Silva 1998). Nonetheless, the various legislative changes to language policy created tremendous uncertainty in legal terms and very real perceptions of discrimination within the Tamil community, which resulted in irreversible damage to racial relations in Sri Lanka.

**Education Policy**

Until the 1970s, Tamil students had extremely strong representation in national universities, with the proportion of Tamil students gaining admission to universities being much higher than the

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173 While religion has not been a central issue of contention, like language and education, Buddhism’s post-colonial revival has been an important factor in defining Sinhalese identity. The measures taken to drive forward Sinhala-Buddhist nationalism, particularly by elements of the Buddhist clergy, have contributed to insecurities among minorities regarding the continued secular nature of the state.
proportion of Tamils in the population. During the 1969–1970 academic year, Tamil university students made up 35 percent of student bodies in science-related fields and as much as 45 percent in medical and engineering fields (De Silva 1998, 335). Factors that contributed to the high proportion of Tamil students securing university admission were the Tamil cultural attitude that places emphasis on education and the fact that many privately funded schools, including a number of Christian missionary schools (Warnapala 1994, 55).

At that time, some in the Sinhalese and Muslim communities expressed resentment about the disproportionate number of Tamil students being admitted to the universities, compared with the number of Tamils in the total population. There were accusations of favoritism toward Tamil students based on certain markers (for example, it was possible to distinguish scripts submitted by Tamil students based on language). The Bandaranaike government responded in the early 1970s by introducing the standardization of university admissions examinations by language. This ensured that Tamil students had to score higher aggregate marks than their Sinhalese counterparts to secure university admission. This was supplemented by a district quota system designed to enable students from more educationally backward districts to obtain a greater share of university places. The government’s policy was influenced by the Sinhalese/Muslim sentiment that the differences in the admissions proportions were due to differentials in educational facilities in the different districts and that equity warranted some re-balancing. This policy created further obstacles for all students from the primarily Tamil Jaffna district and the Colombo district (the multiethnic capital of Sri Lanka with many Tamils).

The medium-wise standardization and district quota system policies were met with very strong opposition in Parliament. A cabinet subcommittee was appointed to deal with the issue; its initial recommendation was to abolish the standardization by language and was very critical of the district quota systems. However, due to the political context, the recommendation was amended to 70 percent of the entrants being admitted to university based on “raw marks” (that is, on merit) and 30 percent on a district basis, of which 15 percent were reserved for students from “educationally backward” areas (De Silva 1998, 311).

Even though the successive policies had a limited impact on the absolute numbers of Tamil students obtaining entrance to university (particularly in the science stream, which saw a decline from 35.3 percent to 33.3 percent in the percentage of Tamil entrants), the unilateral move by the government of changing university admissions policy led to an irreversible breakdown in ethnic relations in the country. This issue was particularly emotional and volatile, given the reliance of the Tamil community on state employment and the importance of higher education in securing these positions. The government’s imposition of these policies to rectify imbalances was unfortunate, particularly as the proportion of Sinhalese obtaining admittance to university and obtaining state employment was on the rise, due to growing educational opportunities and improved economic development in rural Sinhalese areas. The government’s artificial attempts to quicken the pace of such changes had extremely damaging consequences for Sri Lanka’s ethnic harmony.

**Economic Roots of the Conflict**

While political factors dominate the literature on the roots of the conflict in Sri Lanka, important economic factors contributed to the manifestation of violent conflict in the country. Between

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174 A later investigation into this failed to substantiate the accusations (De Silva 1998).
In 1970, Sri Lanka engaged in a complete import-substitution industrialization effort, and the economy all but completely closed to the outside world. This situation continued until 1977, when after a change of regime, Sri Lanka became the first South Asian economy to liberalize. From 1960 to 1977, Sri Lanka’s growth performance stagnated; in that 17-year period, economic growth averaged 3.9 percent. Between 1970 and 1977, growth averaged 3.0 percent. Manufacturing came to a near halt during this period, and the boom in production soon after liberalization underscores the extent of stagnation during the import-substitution period. Between 1978 and 2003, manufacturing output grew at 8.2 percent, compared with 4.8 percent in the period preceding reforms.

The Sri Lankan economy from 1970 to 1977 was particularly weak; job creation was limited as a result of stagnant growth. The Central Bank’s Consumer Finance survey indicated that unemployment had reached 24 percent of the labor force in 1973, while in 1978 it was 14.8 percent, a reduction, but still unacceptably high. As the weak economy could not create wealth, employment resulted in the exclusion of certain segments of society from economic activity and the benefits thereof. The youth, in particular, were excluded from economic activity, evident in the abnormally high rates of youth unemployment throughout the country. In 1978, when total unemployment was 14.8 percent, youth (ages 19–25) unemployment had reached 31.1 percent, according to the Central Bank Consumer Finance and Socio Economic Survey.

By 1981, economic liberalization had taken place, economic activity had been enhanced, and total unemployment had fallen to 11.7 percent; despite these signs of an economic upturn, youth unemployment remained high at 28.8 percent. This can be explained by several factors: New industries created limited numbers of new jobs; several informal rural manufacturing sectors, such as the handloom and cottage sector, were adversely affected by trade liberalization; and formal industries’ employment creation failed to compensate for job losses in the informal sectors. In fact, the adverse, largely unaddressed, negative impacts of the 1977 trade liberalization particularly affected the Northern Province. Income from sales of agricultural produce decreased significantly, undermining livelihoods in the region, due to increased competition from imported products. At this time, youth unemployment was related to the contradictions between Sri Lanka’s labor market and the higher and tertiary education sectors. Because the government covers all costs of education at higher and tertiary levels, students pay no tuition fees. Many students pursue higher education expecting that a university degree will guarantee good job prospects. Unfortunately, the economy has failed to deliver high-end employment. At the same time, employers have reported that new entrants to the Sri Lankan labor market lack essential skills in demand by employers. This trend has continued in Sri Lanka for the past 40 years.

175 The period 1965–1970 saw a regime change, with the UNP capturing power and adopting a mild shift toward liberalization but within an overall framework of import substitution.
177 Atukorala 2006.
178 Other labor surveys indicated high unemployment throughout the 1970s—for instance the 1971 census (19 percent) and the 1975 Land and Labour Utilization Survey (19.9 percent).
180 Dunham and Jayasuriya, 2000, “Equity, Growth and Insurrection.”
182 Ibid.
The role of economic exclusion

Abeyratne (2004) argues that the economic exclusion of youth of all ethnicities has shaped conflict in Sri Lanka. The Janatha Vimukthi Peramuna (JVP)\(^{183}\) uprisings of 1971 and 1987 were largely the result of the economic exclusion of rural Sinhalese youth. According to Abeyratne, both the Tamil Tigers (LTTE) and the JVP are primarily made up of marginalized, unemployed rural youth, and the LTTE is arguably an ethnic manifestation of the frustrations of rural youth. In a 2008 article, Abeyratne\(^{184}\) illustrates the significance of the economic dimension using a comparison between Sri Lanka and Malaysia. By the mid-twentieth century the two countries were functioning on similar socioeconomic platforms (multiethnic countries reliant on plantation exports). Malays made up the majority in Malaysia, but ethnic Chinese dominated the economic spheres. In the immediate post-colonial era, Sri Lanka experienced a similar situation in terms of economic and political distribution of power. In 1970, Tamil university students made up 49 percent of medical students, 48 percent of those in engineering, and 40 percent of students majoring in science. In 1963, the mean income in Tamil communities was LKR 327, the mean income of low-country Sinhalese was LKR 292, and that of Kandyan Sinhalese was LKR 218. Unemployment and underemployment of Tamils in the early 1960s was also much less than that of Sinhalese (Abeyratne 2008). The “corrective” measures taken by the Sri Lankan government (the language policy in 1956 and university admissions on language basis, 1971–1974) were far less ambitious than those undertaken in Malaysia. Abeyratne (2008) says the lack of violent conflict in Malaysia can be attributed to the country’s economic expansion, which generated increased opportunities for all communities. While economic exclusion is one of many factors that contributed to the manifestation of Tamil nationalism, it provided the requisite conditions for violent conflict and is clearly important in terms of understanding the roots of this conflict.

The Emergence of Tamil Militancy

The promulgation of the first Republican Constitution of 1972 marked a turning point for deterioration of ethnic relations in Sri Lanka. The Constitution’s new elements, combined with economic and political developments of the early 1970s, caused a change in the fundamental nature of Tamil opposition to the government of Sri Lanka. By this time, the FP and the CTC had become marginal players, and various Tamil parties combined to form the Tamil United Liberation Front (TULF). The TULF replaced the demand for federalism with a demand for the creation of an independent Tamil nation-state of Eelam (Oberst 1988, 184). This period also saw the emergence of a few Tamil militant groups in the north that demanded a separate state for the Tamil people. One such group was the Liberation Tigers of Tamil Eelam (LTTE/ Tamil Tigers). These groups initially were used by Tamil political parties as instruments to win political power from the state, but the political parties’ influence over these militant groups, especially the LTTE, began to wane by the late 1970s (Narayan Swamy 2004, 49). It has been suggested that the TULF’s demands for a separate state during the 1970s were largely rhetoric, made as bargaining points for negotiating a middle ground with the Sri Lankan government (Narayan Swamy 2004, 37).

Violence was initially manifested on a small scale in the Northern Province with sporadic

\(^{183}\) Janatha Vimukthi Peramuna – now a political party in the Opposition.

attacks against the police and Tamil members of the government, as well as robberies. With time, however, the intensity of these attacks increased, as did the influence of the militant groups relative to the TULF, which was increasingly perceived as being ineffective at securing the interests of the Tamils. The demand for a separate Tamil nation gathered momentum in the mid-to late 1970s. In 1977, the UF government was defeated by a resounding margin by the UNP, which came into power on a platform of introducing market-led economic reforms and measures to address minority concerns.

POLICIES ADDRESSING TAMIL CONCERNS

The second Republican Constitution, passed in 1978, introduced the presidential system to Sri Lanka, akin to the French system, with a president and a prime minister, the latter serving as head of Parliament. The new Constitution also attempted to redress many of the legislative changes that had damaged ethnic relations since independence, especially those related to citizenship, language, and education.

**Citizenship**—A key provision of the 1978 Constitution extended fundamental rights to the entire population, with no differentiation between those who were citizens by registration (Indian Tamils) or by descent. A series of agreements prior to the new Constitution had secured citizenship rights for Indian Tamils, along with agreements with India to repatriate a segment of the Indian Tamil population. Given the early ethnic implications of the Citizenship Act of 1947, these reversals in policy had important implications for perceptions of ethnic conflict.

**Language**—Tamil was made a national language under the new Constitution, thereby legally guaranteeing the provisions of the Tamil Language (Special Provisions) Act. In 1987, the thirteenth amendment to the Constitution would make Tamil an official language, giving it legal parity with the Sinhalese language. The issue of parity of language had been an issue of great sensitivity, particularly considering the Sinhalese fears of Tamil dominance, given the global significance of it compared with Sinhalese, which is spoken only in Sri Lanka. Tamil is spoken in Southeast Asia and South India, particularly in the state of Tamil Nadu.

**Education**—The policy of language-based standardization was abolished. The district-based quotas were amended, more weight was given to merit-based university admission, and the quota for marginalized districts was reduced to 5 percent.

**Devolution of Power**

Despite attempts by the government to address the key issues of contention that had fueled minority insecurities and had caused tremendous tension between the Tamils and the Sinhalese, the violent manifestation of Tamil opposition to the government had gathered sufficient momentum to continue unabated. The outstanding issue was devolution of power. The militant groups would not settle for a power-sharing arrangement. They continued to demand a separate Tamil state. These groups demanded devolution of power in particular, the North and East regions of the island. These areas were claimed to be the “Tamil Homeland,” a term first articulated by the FP, which expressed this as a formal demand following the Official Languages Act. Then Prime Minister S. W. R. D. Bandaranaike entered into negotiations with S. J. V.

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185 These were supplemented by the Grant of Citizenship to Stateless Persons Act No. 5 of 1986 and the Grant of Citizenship (Special Provisions) Act No. 39 of 1988.
Chelvanayakam, the leader of the FP; they agreed to devolve, that is, to delegate power to regional councils. However, as discussed earlier, the Bandaranaike–Chelvanayakam (BC) pact was abandoned, following protests by the opposition groups. In 1965, Dudley Senanayake of the UNP (son of the first Prime Minister D. S. Senanayake) became prime minister by forming an alliance with the FP and the Tamil Congress. Senanayake and Chelvanayakam agreed to a system of devolution of power to district councils, smaller units than the previous regional councils (Sri Lanka has nine provinces and 25 districts). This system was opposed by the opposition, led by Bandaranaike’s widow, and was abandoned in 1968. Given the politically charged nature of the subject and its susceptibility to exploitation for political expediency by the opposition, the issue of devolution was not addressed until the early 1980s with the UNP’s district development councils.

It is interesting to note that the notion of devolution of power to a second tier of government was not a politically charged issue until the 1950s. Until then, there had been a general degree of consensus in government regarding the desirability of devolution of power, recognizing its potential economic and political benefits. As far back as 1928, devolution of power to a second tier of government, representing local bodies, was suggested by the Donoughmore Commission. By 1940, the government in power had all but agreed to implement such a system. It was Sinhalese leaders who placed more emphasis on devolution. In 1926, S. W. R. D. Bandaranaike (who later implemented the Sinhala Only Act) was a strong proponent of the devolution of power (Uyangoda 1994, 96). As the FP’s thrust for self-determination became stronger, in response to the disenfranchisement of Indian Tamils and the Official Language Act of 1956, devolution became a politically charged issue. Since then, devolution has been viewed with suspicion among the Sinhala polity, given this group’s fears that the Sri Lankan nation could be divided along ethnic lines between Sinhalese and Tamils, regardless of the potential economic and political benefits of devolution in terms of delegation of power from the central government to provincial and local governing bodies.

Nonetheless, even today, the ethnic connotations associated with devolution make it nearly impossible to separate the economic and governance dimensions of devolution from the political and ethnic dimensions. Much of this is associated with the demand for the merger of the Northern and Eastern provinces into a single administrative unit, as these two provinces make up the “Tamil Homeland.” The concept of such a homeland is still a matter of significant debate. The Eastern Province in particular has a large proportion of Sinhalese and Muslim residents along with Tamil residents; therefore, the idea of including it as a province combined with the North under majority Tamil rule has faced substantial opposition. As of the 1981 census, the ethnic breakdowns in the three districts of the Eastern Province were as follow:

- Trincomalee: 33.6 percent Sinhalese, 33.8 percent Tamil, 29 percent Muslim
- Batticaloa: 3.2 percent Sinhalese, 70.8 percent Tamil, 24 percent Muslim
- Ampara: 37.6 percent Sinhalese, 20.1 percent Tamil, 41.5 percent Muslim

Tamil leaders, beginning with the FP, have attempted to classify the Eastern Province as a majority “Tamil speaking” area because Eastern Province Muslims speak Tamil. However, Muslims have a distinct ethnic identity, including a different religion and culture from the Tamils. Therefore, Muslims were apprehensive about the potential merger of the North and East into a single political unit. This apprehension was justified on October 22, 1990, when the LTTE ordered all Muslims to leave the North of Sri Lanka within 48 hours (De Silva 1998, 269). The
argument that the Northern and Eastern provinces of Sri Lanka make up the Tamil Homeland has been hotly contested because Tamils who lived in this area were limited to the Jaffna peninsula between the thirteenth and seventeenth centuries. The Eastern Province has by and large been part of the central kingdom of Kandy, and other parts of the North and East have been under the control of various powers over the centuries. De Silva (1998, 153) argues that the primary reference to the Tamil Homeland is derived from a passage by Hugh Cleghorn, a British academic who later became Ceylon’s first colonial secretary in 1799. This passage refers to “The Cingalese [sic] inhabiting the interior of the country in its southern and western parts […] and the Tamils who possess the Northern and Eastern districts.” It is of dubious historical accuracy, given the fact that it claims the Sinhalese originated in Siam [Thailand]. De Silva points out that the territorial dimensions of Eelam, as defined in the Vaddukodai Resolution of 1976, draw on almost exactly the same language as the Cleghorn Minute (see Annex). Cleghorn’s erroneous claim that the Sinhalese people came from Siam caused considerable controversy.

J. R. Jayawardena’s UNP government entered into negotiations with the TULF in the early 1980s to formulate yet another system for devolution of power. The resulting District Development Councils had even less power than the District Councils, negotiated in 1965, with the president appointing the chief executive of each district. The chief executive could not be a resident of the district that he/she would serve. The TULF contested the first election of the District Development Councils in 1981, opposing the councils’ structure for devolution. During the local election campaigns for members of the District Development Councils, extremely violent demonstrations took place, culminating in the burning of the Jaffna library (Wijesinha 2005, 85), an event that fractured racial relations in Sri Lanka. The LTTE gained influence at the expense of the TULF, and violence in Northern Sri Lanka increased. In July 1983, during the TULF annual meeting, the LTTE ambushed and killed thirteen Sri Lankan government soldiers in Jaffna, triggering a major backlash in the South, which set off the worst ethnic riots in Sri Lanka’s history. The riots of “Black July” saw the beginning of a civil war in Sri Lanka that would last until May 2009.

The failure of moderate political attempts at power sharing resulted in descent into violent conflict. The role of political expediency is important here. Previous attempts at power sharing—the Bandaranaike-Chelvanayakam (BC) pact and the Dudley-Chelvanayakam Pact—resulted in the opposition party fueling the fears of the majority Sinhalese population. Negotiations began, and, later, governments were overthrown. The violence pushed the Jayawardena government into negotiating a diluted form of devolution of power, which was not considered acceptable by the Tamil groups. The perceived failure of the TULF to address Tamil aspirations brought about the increased influence of militant groups and diminished faith in political solutions of the conflict. In this context, the attempts at peace building through power sharing to overcome the violent conflict that had gripped the country since 1983 will be explained.

INDO-LANKA ACCORD AND THE PROVINCIAL COUNCIL SYSTEM

The riots of July 1983 resulted in India intervening in the Sri Lankan situation. Several factors influenced India’s intervention; these are explained in detail in the memoir of J. N. Dixit, the

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186 The “Kingdom of Kandy” was the last autonomous region that was governed by Sri Lankan kings even during periods of colonial control. The Kandy Kingdom was predominantly made up of Sinhalese.

187 It is commonly accepted that the Sinhalese originated from northeastern India.
Indian High Commissioner to Sri Lanka at the time, and summarized below (Dixit 1998, 20, 133).

1. Tamil Nadu (the southern Indian state with a predominantly Tamil population), which has a history of pushing for secession from the Hindi-dominant Indian Union, pressured India to intervene.
2. Sri Lanka’s increasing diplomatic and strategic proximity to the United States, for example, a Voice of America broadcasting facility was located in Chillaw; Sri Lanka’s opposition to Russia’s invasion of Afghanistan; and its support for the UK’s invasion of the Falkland Islands—one of these positions were looked upon favorably by India.
3. The contract for the repair of the Trincomalee oil tank farms to a consortium of firms with close ties to America was perceived as a move by the West to set up a naval base in Trincomalee.
4. Sri Lanka had close security-related ties with Pakistan, China, and Israel, which further concerned India.

In 1985, the Sri Lankan government and Tamil political parties and military groups entered into two rounds of peace talks held in Thimphu, Bhutan. Indian Foreign Secretary Romesh Bhandari mediated the talks. The Tamil groups made the following demands:

1. Devolution of power with provinces as the unit of devolution.
2. All aspects of inequality due to Sinhala Only Policy to be reversed legally, constitutionally, and politically.
3. The NE [Northern and Eastern provinces] to be linked into a single province and named “Tamil Homeland” in the Constitution.
5. Return lands in the NCP [North Central Province] (taken for resettlement of peasants associated with the Mahaweli irrigation scheme) to the Tamil people.
6. Tamil to be made an official language with equal status to Sinhalese.
7. Proportional representation for Tamils in the armed forces, police, and civil service.
8. Sri Lankan armed forces to be returned to barracks.
9. Repeal the sixth amendment to the Constitution.

Note that the sixth amendment to the Constitution prevents any member of Parliament (MP) from supporting the division of the territorial integrity of Sri Lanka. This legislation was passed soon after the July 1983 riots and resulted in the TULF MPs abdicating their seats.

Both rounds of Thimphu talks failed, given the limited commitment both sides had to a genuine negotiation, as discussions did not delve into substantive issues but stagnated on legal and procedural technicalities. The Sri Lankan government was suspicious of Indian intervention as a mediator as substantial evidence that India was involved in training Tamil rebel groups existed (Dixit 1998, 78). Military tensions built up in Sri Lanka following the collapse of the Thimphu talks, despite progress on the power sharing dialogue through processes such as the

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188 EROS, TELO, EPRLF, and LTTE were the Tamil military groups included under the Eelam National Liberation Front, and TULF and PLOTE were the Tamil political parties (Guruge 2006, 50).
The Delhi Accord\textsuperscript{189} and the formation of an All Party Conference (APC) to deliberate on that accord. On 26\textsuperscript{th} of May 1987, the Sri Lankan military launched an offensive against the LTTE in the North, following a spate of attacks on civilian and economic targets in the South.\textsuperscript{190} As the military battle intensified, India demanded a halt to the operation. To quote the Indian High Commissioner at the time, “India would not allow the capture of Jaffna and the persecution of civilian population there and if Indian advice was not accepted, India would provide logistical support to the LTTE” (Dixit 1998, 98). On June 4, 1987 the Indian Air Force invaded Sri Lanka’s airspace over the Jaffna peninsula and dropped food parcels in to the Jaffna peninsula that was being approached by the Sri Lankan armed forces. This was seen by many as India directly aiding the LTTE, when it was clear that it faced military defeat by the Sri Lankan army.

**The Indo-Lanka Accord**

President J. R. Jayawardena bowed to the geopolitical realities faced by Sri Lanka and signed the Indo-Lanka Accord on July 29, 1987, under extremely tense circumstances in Colombo. The agreement linked the Northern and Eastern provinces of Sri Lanka, subject to a referendum in the Eastern Province to be held in the future. This referendum never took place; Jayawardena officially authorized the linkage of the two provinces in September 1988 (De Silva 1998, 239). Tamil was made an official language by the thirteenth amendment to the Constitution, along with its status as a national language, making it on par with Sinhalese as the two official languages of administration, legislation, the courts, and education. English was stipulated as a link language. (English was used as a language of administration in different government institutions but the language was not elevated to the “official” status).

The side letters of the agreement also secured India’s strategic foreign policy objectives, as they committed Sri Lanka to (1) not allow the use of its ports by any country for military purposes in a way prejudicial to India’s interests, (2) to review broadcasting agreements with foreign partners, and (3) to assure the Indian government that all foreign military and intelligence personnel on the island would not undermine India’s interests. The constitutional validity of the thirteenth amendment was put before the Supreme Court, which ruled in favor of the Indo-Lanka Accord by just one vote. On November 12, 1987, Sri Lanka’s Parliament approved the thirteenth amendment; 138 members voted for it, and 11 voted against it.

The Indian Peace Keeping Force (IPKF) arrived in Sri Lanka to support the implementation of the Accord after the signing on the Indo-Lanka Accord on July 29, 1987. While many Tamil groups began to hand over their weapons to the IPKF, the LTTE defied the force, despite initially agreeing to the Accord. The Indo-Lanka Accord and the thirteenth amendment addressed most of the key Thimphu principles, including the devolution of power to the provinces, making Tamil an official language, the merger of the Northern and Eastern provinces, and recognition of these provinces as “areas of historical habitation of Tamil speaking people.” Despite the political risks taken by the government in agreeing to these changes, the LTTE failed to abide by the Accord—thereby casting serious doubt over their commitment to a

\textsuperscript{189} The Delhi Accord was the result of discussions between Sri Lanka’s chief negotiator at Thimphu, Harry Jayawardena, brother of President J. R Jayawardena, and Indian Foreign Secretary Bandhari and Indian constitutional expert Balakrishnan.

\textsuperscript{190} A bomb in Pettah market killed more than 100 people, a bomb on the Trincomalee-Habarana bus killed 125 killed, and an attack on Katunayaka airport causing loss to civilian life. Available at- http://www.defence.lk/LTTE%20Attrocities/Atro2.xml
peaceful resolution to the conflict. In the second week of October 1988, the IPKF launched operations against the LTTE to disarm them forcibly, a dramatic turn of events considering India’s efforts to prevent the Sri Lankan military from achieving the same objective a few months earlier.

The Provincial Council (PC) System

The key aspect of the Indo-Lanka Accord relevant to this chapter is the inclusion of the thirteenth amendment to the Constitution of Sri Lanka, which would create a second tier of government, devolving power to the eight provinces (considering the merger of the Northern and Eastern provinces). Despite the LTTE’s refusal to engage constructively in the process, the Provincial Council (PC) system became the significant power-sharing system, which is still functioning in Sri Lanka, and is, therefore, at the heart of any discussion on power sharing in the Sri Lankan context. The system has numerous flaws in its drafting and in the spirit in which it has been implemented. As a result, the economic and administrative costs of the PC system have been extensive. Having achieved its foreign policy objectives, India did not place a great deal of emphasis on the follow-through implementation of the PC system. The provisions of the PC system were drawn to a great extent from the Delhi Accord and the subsequent December 19th Proposals, the product of negotiations led by Indian ministers P. Chidambaram and Natwar Singh in 1986. Accordingly, the resultant PC system was not borne out of a compromise reflecting the organic features of Sri Lanka’s socioeconomic and political characteristics. It was, instead, an externally imposed structure with minimal adaptation to the Sri Lankan context.

Weaknesses in the Implementation of the Thirteenth Amendment

Ever since the PC structure became part of Sri Lanka’s Constitution, its implementation has reflected the weaknesses inherent in a system that was not designed to meet Sri Lanka’s specific needs. Successive Sri Lankan governments have taken measures to concentrate power in the center, with a major objective to sustain the unitary state (as expressed in Article 2, Chapter 1 of the Constitution) controlled by the central government. For instance, the central government has created national-level institutions that have usurped provincial power, exercising control over finances and through the courts.\(^\text{191}\) The division of responsibilities between the central government and the provinces is arranged through three lists. The provincial list contains exclusive responsibilities of the provincial administration, the reserved list is the exclusive domain of the central government, and the concurrent list allows shared responsibility. A key item in the concurrent list says, “National policy on all subjects and functions,” which the central government has interpreted to justify its influence over all activity areas of the Provincial Councils. For example, in health and education, the central government has undermined the relevance of provincial governments by creating “national schools” and “national hospitals,” which enjoy far superior resources compared with their provincial equivalents. The same applies to roads, income transfer schemes, and many other functions. The public perception of the PC system has also been undermined because the PCs appear to be duplicating resources—whereas the PCs have been sidelined from activities that they should legitimately pursue. Since the PCs’ inception, there have been constant allegations that the central government treated the Concurrent List as the Reserved List (Shastri 1994, 215). The system of three lists (List I:

Provincial Councils List, List II: Reserved List, and List III: Concurrent List) was derived from the Indian framework and was first discussed as part of the Delhi Accord. Its effective functioning depends on the central government’s commitment to devolution. The three lists provide the flexibility for a central government to capture power from lower tiers and is not entirely suitable for the political context of Sri Lanka, where the commitment of central governments to devolution of power has been called into doubt. Future Sri Lankan power-sharing arrangements may have to eliminate a concurrent list. Another feature of power sharing through the PC system has been the dependence of provincial governments on the central government for finances and liquidity. Less than one-fifth of the Provincial Councils’ expenditures are funded through the councils’ own indirect taxation and other revenue sources such as vehicle licenses (US AID 2005, 22). This gap has to be bridged by central government grants, which has caused the provincial councils to become dependent on the central government. One option for overcoming this would be to shift to a system of revenue sharing (Wanasinghe 2006, 10). Provincial Councils also have very limited control over their human resources. Employees of PCs are drawn from the All Island Administrative Service—a central body of civil servants. The PC has limited control over recruitment and transfers; these civil servants have limited incentives to improve their job performances and little allegiance to the PC to which they have been assigned. The system would be far more effective if PCs were empowered to hire staff from a provincial civil service, provide them with the requisite human resource development, and obtain the best level of productivity from their employees (Wanasinghe 2006, 134–135).

An examination of the provisions and structures of Sri Lanka’s current power-sharing mechanism shows that the PC system has numerous faults, which have brought about economic inefficiencies and substantial weaknesses in effective power sharing. These failures have greatly undermined citizens’ political support for the PC system because they see that public funds are wasted, they face administrative burdens in day-to-day life, and they receive limited benefits from this system. The PC system is inefficient because it is inadequately financed, has weak human resource management capacity, and the PCs’ work is duplicated by the central government. Considering the fact that Sri Lankan political actors had limited involvement in the design of the PC system, which was imposed through Indian intervention, the lack of enthusiasm for its effective implementation is hardly surprising.

FAILURE OF ENSUING PEACE PROCESSES

The Indo-Lanka Accord and the Provincial Council system failed to secure peace in Sri Lanka. The Liberation Tigers of Tamil Eelam (LTTE) successfully battled the Indian Peace Keeping Force (IPKF). Two major peace processes were undertaken in the 1990s, and neither one dealt with power-sharing issues in a meaningful manner.

Premadasa—LTTE Talks 1989–1990

In April 1989, the President of Sri Lanka, Ranasinghe Premadasa, invited the LTTE to peace talks, based to a great extent on the government’s and the Tamil Tigers’ common opposition to the continued presence of the IPKF. At this time, both major groups were experiencing military

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fatigue, the LTTE from fighting the IPKF and the government of Sri Lanka (GoSL) troops from fighting the second Southern insurgency in the form of the Janatha Vimukthi Peramuna (JVP).

The peace talks focused on logistical issues relating to the withdrawal of the IPKF, economic issues faced by the populations of the Northern and Eastern provinces, paramilitary actors, and population shifts due to irrigation programs. Power-sharing issues did not feature in the talks, which broke down because (1) the government did not meet the LTTE’s demands to abolish the sixth amendment to the Constitution and (2) the dissolution of the North Eastern Provincial council (controlled by the IPKF-backed EPRLF, a rival Tamil group) was delayed. The Sri Lankan government was unable to deliver on these issues due to a lack of domestic political stability. As the government was not supported by a two-thirds majority in Parliament, any constitutional changes were impossible. This reduced the credibility of the government’s negotiating positions. Furthermore, the government had difficulty negotiating political issues because its opponents—both within and outside the ruling party—objected to significant concessions the government was making to the LTTE, particularly in the context of the Unilateral Declaration of Independence by the chief minister of the North Eastern Provincial Council. The LTTE also continued to engage in political assassinations in the South, which showed its lack of trust in the negotiations. Eventually hostilities resumed as the LTTE killed 600 unarmed policemen in the East.

Kumaratunga—LTTE Talks 1994–1995

After the general election of 1994, the People’s Alliance (led by the Sri Lanka Freedom Party—SLFP – headed by Chandrika Kumaratunga, daughter of S.W.R.D Bandaranaike) came into power on a peace mandate, securing significant majorities in both Sinhalese and Tamil areas of the country. Talks between the LTTE and the government had commenced in October 1994, but once again the LTTE insisted on a stage by stage approach to ensure a “return to normalcy” in the North East prior to discussions on substantive political issues. The government maintained the position that power-sharing and political issues could be discussed simultaneously. The LTTE’s lack of desire to engage in political dialogue reinforced suspicions in the South that the organization had limited genuine interest in a political solution to the conflict. This view was reinforced by the LTTE’s attack on a naval vessel the day before the first round of talks; the killing of UNP presidential candidate Gamini Dissanayake by a suicide bomber shortly before the second round of talks. Many of the LTTE’s demands that the government help the northeastern region return to normalcy were strategically important, including (1) removal of the list of items embargoed from the North; (2) closing the strategically important Pooneryn Army Camp (to facilitate civilian movement—the government withdrew the forward defense line of the camp by 600 meters); and (3) removal of fishing restrictions (the government removed fishing restrictions except around army camps, harbors, and other strategic locations). As the military was suspicious of the LTTE’s intentions and had reservations regarding some of the compromises negotiated by the government, implementation of the compromises met with a degree of inertia (Perera 2006, 220). As the talks progressed, the two parties’ lack of mutual trust

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193 In fact, the presidential election was won by a very narrow margin, and the result was challenged by the opposition candidate.

194 Victims of LTTE assassinations were Sam Thambimuttu, S.Amirthalingam, and Rajini Thiranagama.

195 The LTTE remained unsatisfied even when the banned items were limited to ammunition, explosives, remote control devices, binoculars, telescopes, compasses, penlight batteries, and cloth material resembling army uniforms.
increased. For the fourth (and final) round of talks on April 10, 1995, the government requested that parallel committees be formed to deal with reconstruction and development, strengthening of the cessation of hostilities agreement, and power-sharing issues. However, in setting the agenda for the talks, the LTTE stated that the climate for political talks remained unfavorable. On April 19, the LTTE unilaterally withdrew from the peace process by attacking the Trincomalee Naval Harbor.

The disappointing outcomes of the 1994–1995 peace process eroded public confidence in the possibility of a negotiated settlement of the conflict. Nonetheless, President Kumaratunga announced a “devolution package” in 1995 that would have significantly enhanced the power-sharing provisions of the existing PC system. The government attempted to make these changes part of the Constitution in 2000 but failed to obtain the requisite two-thirds parliamentary majority as the opposition UNP opposed it. This was another instance of political expediency undermining the push for a Southern consensus on a peaceful settlement to the conflict (the UNP later attempted to bring in a more far-reaching agreement to the one they opposed). The LTTE, following a series of military victories, indicated the desire to return to the negotiating table by declaring a cease-fire in December 2000; however, the government’s response was less than lukewarm, based on its experiences of the previous talks (Uyangoda 2006, 238). Mutual mistrust continued to be a major stumbling block for the pursuit of a negotiated settlement.

**Wickremesinghe–LTTE Talks 2002–2003**

The general elections of 2001 saw the UNP-led coalition, the United National Front (UNF), come into power (the presidency remained with Kumaratunga of the SLFP). Both the LTTE and the government were eager for a respite from the war, given the heavy casualties on both sides from recent battles; economic malaise (Sri Lanka recorded a GDP contraction of 1.5 percent in 2001, following a drought and the LTTE attack on the international airport in July 2001); and the compromised international situation faced by the LTTE in the wake of the events of September 11, 2001. Six rounds of peace talks took place between September 2002 and March 2003, but a ceasefire agreement held (in theory) from February 2002 until January 2008. Power sharing was on the agenda during these talks. During the third round of talks in Oslo, December 2002, the LTTE agreed to explore the possibility of internal self-determination within a united Sri Lanka but without completely abandoning the idea of secession (Peiris 2009, 107). The LTTE withdrew from the peace talks following the sixth round in March 2003, citing its exclusion from participating in the Washington donor conference, and called for the creation of an interim administration for the North East.

In July 2003, during the Tokyo donor conference, donors pledged up to US$4.5 billion to Sri Lanka, conditional upon tangible progress in peace negotiations. Spurred by the carrot of aid, the government proposed a provincial administration structure (PAS). The PAS would have representation from the government, LTTE, and Sri Lanka /Muslim Congress (SLMC) but with a LTTE majority. Sinhalese and Muslim representation would be according to provincial population ratios. The PAS had no provisions for control over police, land, or revenue generation; instead, it would be financed through grants from the government and the North East Reconstruction Fund (NERF), managed by the World Bank. Despite the PAS giving the LTTE majority control over the administration of the region, the LTTE rejected the PAS. Peiris (2009) suggests that a reason for LTTE’s rejection of the PAS was that it would further engage LTTE in the “international safety net,” a key strategy employed by the UNF to engage as key stakeholders
in the peace process major international powers, including the United States, the European Union, Japan, and India, to ensure that any reneging of power-sharing agreements by LTTE (secession) would not be tolerated by the international community, rendering such a move futile (Peiris 2009, 138). As it rejected the PAS, LTTE proposed a more far-reaching interim self-governing authority (ISGA).

The ISGA went beyond the PAS by including, among other factors, control over internal and external borrowing, regulation of international trade, and regulation of access to coasts. Amid widespread opposition to the ISGA in the South, President Kumaratunga took over the key ministries of Defence, Interior, and Mass Communication on November 4, 2003. She then dissolved Parliament and called a general election, which the ruling UNF lost, restoring to power the United People’s Freedom Alliance (UPFA), the coalition led by the SLFP, Kumaratunga’s party. This was another manifestation of the lack of political consensus that undermined efforts to drive forward a peace process, coupled with the ruling party’s lack of political stability.

**Presidential Election 2005 and the End of the War**

In November 2005, the presidential election was contested by Mahinda Rajapaksa of the UPFA, who opposed the ISGA and a federal solution to the conflict; he promised to re-negotiate the Cease Fire Agreement (CFA) and bring about an “honourable peace.” The UNP’s candidate was Ranil Wickremesinghe, who was in favor of extensive power sharing within a federal state. The election was very close, and the result was eventually determined by the fact that the LTTE enforced a boycott of the vote in the Northern Province (population 1 million, according to 2001 census), which traditionally backed the UNP over the SLFP and was expected to do the same. Rajapaksa won by 181,786 votes (50.26 percent). The Jaffna district (population close to 490,000, according to 2001 census) turnout was just 1.2 percent compared with 19.2 percent in 1994.

Peiris (2009) argues that LTTE leaders pushed for a Rajapaksa win because they expected that the UPFA, driven by hard-line coalition partners, the JVP and the JHU, would return to war, which would justify a LTTE military response. This was plausible, considering that the LTTE constantly provoked the Sri Lankan military, attempting to elicit a response without success. These actions by the LTTE gave further credence to claims that the LTTE had rarely if ever been genuinely committed to a negotiated solution to the conflict. In July 2006, the LTTE closed the Mavil Aru anicut, depriving several villages of water in the East. On July 26, the army launched an offensive to recapture the area, which became a full military offensive that ended in May 2009 with the elimination of the LTTE leadership and the organization’s military capacity.

**POST-CONFLICT ECONOMIC POLICY**

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196 JHU stands for Jathika Hela Urumaya (National Heritage Party), which is led by Buddhist monks.

197 In April 2006, army commander General Sarath Fonseka survived a suicide bomber's attack on his motorcade; 64 people were killed in an attack on a bus in Kebathigollawa; Sea Tigers (the naval wing of LTTE) attacked a navy ship carrying 700 soldiers in May 2006 but the attack was foiled by the navy; in June 2006, the deputy chief of staff of the army was killed; and on June 19, 2006, an attack on a Colombo port was foiled.

198 An anicut is a dam for regulating the flow of water in an irrigation system.
This chapter has emphasized the role of political power-sharing measures in the prospects for sustainable peace and development in post-conflict Sri Lanka. This reflects the fact that while the conflict has had important economic implications for Sri Lanka, it is the political dimensions that are critical for sustainable post-conflict peace and development. Sri Lanka’s economy has continued to grow at a steady pace (but below its potential), with average annual growth of approximately 5 percent, even during conflict years. Nonetheless, since the conflict ended, the Northern and the Eastern provinces have seen tremendous economic disfigurement in terms of destruction of productive capacity, erosion of human capital, through death, migration, militarization, and stunted educational attainment. Therefore, post-conflict economic policies must be approached through two lenses—the macro framework and microeconomic issues in the North and East.

**Macroeconomic Policy Priorities**

The primary macroeconomic policy issue that requires attention in the post-conflict situation is fiscal policy. Sri Lanka has averaged fiscal deficits from 8 to 10 percent annually, caused by high military spending and decreased revenues due to the conflict (Arunatilake 1998). The fiscal position, in turn, has influenced monetary policy as the Central Bank199 maintained near-zero or negative real interest rates during certain periods to ease borrowing conditions for the government, which resulted in above average inflation, averaging 10 percent annually.200

Sri Lanka also narrowly averted a balance of payments crisis in early 2009 as a result of a currency peg, put into place by the need to prevent currency depreciation, which would have increased government foreign debt repayment requirements. The global economic crisis of 2008–2009 has had negative impacts on the Sri Lankan economy in terms of export performance and on the revenue side of fiscal policy. However, it has helped bring down inflation rapidly, as prices of global commodities have declined sharply, which has also contributed to an easing of the balance of payments position. This will support post-conflict economic development by creating a more conducive environment for investment, both in the post-conflict regions and the entire country. Therefore, it is essential that state expenditures are rationalized and revenue sources are strengthened in the short term. In the post-war context, investment and economic growth are expected to expand significantly, as the security climate improves. However, bottlenecks remain, including the high cost of energy, weaknesses in the quality of connections throughout the transportation network, and persisting transaction costs of doing business. In short, from a macroeconomic policy perspective, the policy requirements for the post-conflict situation are simply the standard policy issues that have acted as constraints to smooth economic development in Sri Lanka.

Figure 1 shows Sri Lanka’s macroeconomic aggregates from 1992 through 2009. The column on the left indicates percentages

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199 The Central Bank governor, appointed by the president and the secretary to the Treasury, sits on the monetary board of the Central Bank.

Microeconomic Issues

The regeneration of economic activity in the post-conflict provinces is essential to securing a durable peace in Sri Lanka. The role of economic exclusion, particularly youth unemployment, in influencing conflict was outlined above. It is essential that post-conflict economic policy emphasizes the creation of jobs, particularly in the post-conflict provinces. In the short term, measures will need to be taken to ease productivity constraints to sectors such as agriculture, fisheries, and tourism. Rehabilitation of irrigation systems, storage and transportation networks, and connective infrastructure to improve transportation to key domestic and international markets are essential. These sectors are important as they were the economic strengths of these regions prior to the conflict. In the longer term, it is important to enhance human resource development in the post-conflict regions, creating suitable conditions for higher levels of employment. Enhancing access to higher education and professional qualifications will be important. It is also important to establish property rights quickly, particularly for displaced individuals, and to set up credit markets in post-conflict areas to enable rapid transition to productive economic engagement. External remittances have also long been a source of stability and emergency finance in the North and East. These sources of finance are in place, but more efficient fund transfers can be enhanced by improved distribution of formal financial market networks in the North and East and by acting to reduce the transaction costs associated with such financial transfers. At the same time, illegal transmission of finances (akin to those that funded LTTE operations for two and a half decades) must be prevented.

POST WAR TRENDS AND POLICY OPTIONS
With the end of the military conflict in Sri Lanka in May 2009, the requirement and modalities of power sharing have been substantially reconsidered. One school of thought is that the focus should be development of post-conflict areas to enable the inhabitants of these regions to return to normalcy before making decisions on political reform. This has some merit. While a quick implementation of a long-term political process will be beneficial in terms of locking in the peace, it is not advisable that such a process be rushed so as to lose sight of important functional modalities, particularly in the context of contemporary weaknesses in Tamil political representation.

As soon as the military campaign came to an end, the government’s initial thrust was to implement the thirteenth amendment to the Constitution completely. In his victory address on May 19, 2009, President Rajapaksa made this clear. However, since then the debate has moved toward the concept of a “home grown” solution, particularly considering that the thirteenth amendment was by and large thrust upon Sri Lanka by India. It is clear that the amendment’s provisions are not ideal in the current sociopolitical context of Sri Lanka (for example, the complicated three lists) and that the system requires substantial reform. The concept of a homegrown solution could refer to these reforms or to an entirely new power-sharing structure—either way, a constitutional amendment would be required, which entails the support of two-thirds of the members of Parliament. At the time of writing, this had been secured by the UPFA government. Therefore one major stumbling block for previous attempts at power-sharing agreements—the lack of political stability—is not an issue.

More recently, the very need for power sharing in Sri Lanka has also been called into question. The argument is that the major issues of contention, such as language and higher education, have been addressed by prior constitutional amendments. Thus, many of the grievances that gave rise to calls by Tamils for self-determination have been addressed. However, it could be argued that the fundamental desire for power sharing by minorities is based upon the need to have some degree of protection from the possibility of such issues of contention arising again. The issues of contention need not be the very same issues that arose in the 1950s and 1970s; therefore, a degree of regional autonomy would provide a more blanket protection. The sensitivities surrounding these subjects are related to insecurities regarding the possible secession of certain provinces—particularly considering neighboring geopolitical realities. This issue could have been, and, to an extent, has been addressed by strong constitutional provisions preventing the justification for secession and equally strong protection for minorities, which, in turn, would never provide a sufficient justification for secession. If there is no justification for secession, international support for such a move would be very limited, which would be a sufficient deterrent to secession. Significantly, decentralized administration and devolution of power were accepted and recognized to a great extent as useful tools of governance and administration in Ceylon prior to independence (see above). An effective system of devolution of power according to the principle of subsidiarity\footnote{The principle of subsidiarity means the central authority should only perform functions that provincial and local authorities cannot perform more efficiently.} will enhance the quality and efficiency of service delivery by improving the accountability of local political actors to the voters. The potential benefits of stronger local governance have been misunderstood, overshadowed by arguments against devolution, based on critiques of the “traditional homelands” issue and the fact that the majority of Tamils now live outside the North East. However, getting bogged down in these arguments will result in a failure to see beyond the ethnic connotations of devolution and will lead to losing out on its potential benefits.
The other arguments against devolution of power have been based on the economic inefficiencies that have plagued Sri Lanka’s power-sharing system. In earlier sections of this chapter, we have demonstrated that these inefficiencies were brought about by weaknesses in the framing of the power-sharing agreement and by the lack of political commitment to the agreement on the part of Sri Lanka’s leadership. The current PC system is debilitated by significant overlaps of function, duplication of resources, and wasteful bureaucratic burdens. A better defined power-sharing mechanism needs to be created and implemented after a thorough study of the sociopolitical and economic realities of the country and after the new system has significant political support and broad commitment. A more effective power-sharing mechanism could possibly include elimination of the concurrent list, revenue sharing instead of grants, and a provincial public service with PC control over recruitment and human resource development.

The importance of political support for a power-sharing mechanism is clearly demonstrated by the weaknesses that resulted from the lack of political commitment to devolution through the externally-influenced PC system. However, the economic arguments against devolution go beyond the issues of inefficient administration. One of the major obstacles to economic development in Sri Lanka has been the state’s inability to push through unpopular but necessary economic policies. One reason for this has been the coalition-style governments’ proportional representation electoral system, which has made governments reluctant to engage in necessary reforms for fear of losing political support. Some argue that devolution of political power will further weaken the central government’s ability to undertake tough economic choices. The coordination of macroeconomic, particularly fiscal, policy will be another significant challenge. This is particularly problematic because a provincial government does not have to face the consequences of national debt and its implications on issues such as monetary policy. The question, then, is whether Sri Lanka’s economic policy-making structures are mature enough to meet the challenge of devolution of economic power. This remains an open question. What is clear is that the issue of devolution is a political issue with economic consequences. There are both political and economic arguments for and against devolution and power sharing.

One of the biggest problems being faced is the lack of an effective articulation of the political aspirations of the Tamil population of Sri Lanka. We have argued that the LTTE had limited commitment to a peaceful resolution to the conflict and that with the LTTE out of the picture, the prospects for peace are enhanced. However, the LTTE made every effort to eliminate all Tamil voices that were not in line with its own aims—examples include Neelam Thiruchelvam, a lawyer and moderate Tamil advocate of devolution; A. Amirthalingam, the leader of the Tamil United Liberation Front (TULF); Sri Sabarathnam, leader of the Tamil Eelam Liberation Organization (TELO); Rajini Thirangama, a human rights activist and author; and numerous attempts on the life of Douglas Devananda, the leader of the Eelam People’s Democratic Party (EPDP). Several other Tamil political leaders have been victims of political assassinations through inter-party rivalries. In 2001, remaining Tamil parties formed the Tamil National Alliance (TNA), which later splintered as the TULF and the Tamil Congress left the TNA because the Tamil Congress took the position that the LTTE was the sole legitimate representative of the Tamil people and continued to push for secession. The remainder of the TNA was perceived as a LTTE proxy and, therefore, had limited legitimacy in the South. In April 2010, the TNA dropped the call for secession and contested the General Election on a campaign for federalism. The election saw 13 TNA MPs elected to parliament from the Northern (eight out of fifteen seats) and Eastern provinces (five out of sixteen seats). The TULF and Tamil

202 The victims of these assassinations were Nadarajah Raviraj, Kidnan Sivanesan, and Joseph Pararajasingham.
Congress won no seats in the election. It is clear that support for the TNA, even in the North East, is not unanimous. The situation is complicated by the fact that more than half of the country’s Tamil population live outside the North and East. Therefore, there would be limited effective representation of Tamil interests in a possible future power-sharing negotiation. The provisions of such a power-sharing agreement will depend to a great extent on the unilateral measures of the ruling party, particularly as the requisite two-thirds majority of Parliament has been achieved. The viability of external influence in a future power-sharing agreement to fill this political vacuum is also compromised by the experiences of the Indo-Lanka Accord and the resultant flawed PC system. Nonetheless, the absence of a domestic Tamil political voice has led to increased prominence of the Sri Lankan Tamil diaspora, now residing in Western nations. Such groups could pose future security threats to Sri Lanka; serious questions have arisen about the legitimacy of diaspora groups in voicing the political aspirations of Tamils residing in Sri Lanka. Given this background, it is all the more essential that Tamil political aspirations find articulation through Sri Lanka’s political mainstream.

The LTTE hijacked the political process that was embarked upon by the Federal Party, and later the TULF converted it into a terrorist agenda, which clouded the underlying political issues that were the true sources of conflict in Sri Lanka. In this context, finding a “home-grown” solution to the needs of all the communities in the country becomes ever more challenging. Considering that devolution of power and decentralized administration can produce economic benefits if properly implemented (and this was recognized even before the Donoughmore Commission in the 1930s), and that they could reap political benefits that might have mediated and found solutions to ease ethnic tensions even prior to the LTTE, the logical way forward would be power sharing by devolution. This would provide insurance against future political actors engaging in majoritarian policies for political expediency at the expense of minority groups. However, the modalities of a power-sharing system through devolution would need to be considered carefully, taking into account the flaws of the PC system and the adverse economic consequences that resulted. At this stage, macroeconomic policy structures would need to adapt and mature accordingly, to be able to meet the new challenges resulting from any possible power-sharing arrangement effectively. While political structural measures, such as formal power sharing, are important for durable peace and development in Sri Lanka, it is essential that parallel measures are taken to heal the deeper rifts within society caused by the conflict. Efforts at reconciliation through all levels of society, particularly among groups in the North, East, and the South, will be extremely important, and policies that encourage further cleavages in society (for instance, the language-based separation of students in schools) will need to be re-visited. Though ethnic tensions have fractured Sri Lanka in the post-independence era, with the end of the civil war in May 2009, the country has an unprecedented opportunity to take steps to repair some of these fractures. In this chapter we have outlined some of the key political and economic policy options that could support such efforts.
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<th>Issues Raised</th>
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<tr>
<td>The official war between the LTTE and the GoSL ended on May 19, 2009. The end of the war does not guarantee sustainable peace in the country since the war was a violent manifestation of deeper political tensions between the two major ethnic groups – the Sinhalese and the Tamils.</td>
<td>Therefore the need for a broader political solution to the ethnic issue in Sri Lanka remains. A “Political Solution” to the ethnic problem is needed. There is an understanding that this “solution” has to be home grown, given the past failures of externally driven solutions.</td>
</tr>
<tr>
<td>The major causes of the conflict in Sri Lanka can be seen in the post independence policies that were enacted by successive governments. These policies had majoritarian tendencies, which undermined minority interests (citizenship act, language and higher education), if not always in practice, in terms of perceptions. These policies were the result of short term political expediency.</td>
<td>In the last 30 years, laws that were deemed majoritarian have been either repealed or amended to address minority issues. However, in some cases practical problems remain, particularly with regard to language, as many government officials are not bi-lingual, thereby undermining the official bi-lingual policy of the state. Recent steps have been taken to address this as public officers require command of both national languages for career progression</td>
</tr>
<tr>
<td>Sri Lanka followed a closed economic policy throughout the 1960s and 1970s. Economic policy failure helped create an environment conducive to armed conflict with high youth unemployment and economic stagnation.</td>
<td>The importance of economic development to lock in peace is emphasized by this. This has particular ramifications for post conflict economic policy in the conflict affected provinces of the North and East – specially with regard to employment creation in the short term and long run.</td>
</tr>
<tr>
<td>Failures of previous attempts at power sharing and peace negotiations. The Indo-Lanka Accord and the failure of an externally driven power sharing mechanism (the Provincial Council (PC) system- under the 13th amendment to the constitution) that had little domestic political support and was not based on socio-economic realities in Sri Lanka.</td>
<td>There is an important argument that in order to address the grievances of the minorities there has to be system of power sharing between the center and the provinces. However broad based political support is essential to ensure the sustainability of such an effort. Therefore it is important that the economic and governance benefits of devolution are reaped through an effective policy structure in this regard.</td>
</tr>
<tr>
<td>The lack of effective Tamil political representation to articulate the political aspirations of the Tamil polity. The Tamil polity is highly fragmented and thus there has been no coherent articulation of political aspirations.</td>
<td>There will be little progress toward a political solution unless the Tamil polity can come together on a common platform. This of course could take time given the more urgent needs of reconstructing economic, social and then political infrastructure.</td>
</tr>
</tbody>
</table>
ANNEX 1

Clagehorn Minute (as quoted in K.M. de Silva 1998)

Two different nations, from a very ancient period, have divided between them the possession of the island. First the Cingalese (sic) inhabiting the interior of the country, in its southern and western parts, from the river Walouve (sic – Walawe) to that of Chilow (sic – Chillaw), and secondly the Malabars (Tamils), who possess the northern and eastern districts. These two nations differ entirely in their religion, language and manners. The former, who are allowed to be the earlier settlers, derive their origin from Siam, professing the ancient religion of that country.

Extract from Vaddukodai resolution of 1976 (as quoted in K.M. de Silva 1998)

Whereas throughout the centuries from the dawn of history, the Sinhalese and Tamil nations have divided between them the possession of Ceylon, the Sinhalese inhabiting the interior parts of the country in its southern and western parts from the river Walawe to that of Chilaw and the Tamils possessing the northern and eastern districts […] (the TULF resolves that) Tanuk Eelam shall consist of the Northern and Eastern Provinces (of Sri Lanka).
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Sudan: Multiple Transitions 2005-2011, Analyzing the Dynamics of Post-Conflict Impasse

Ibrahim Ahmed Elbadawi and Atta El-Battahani

INTRODUCTION

Sudan, the largest country in Africa, had successfully concluded a peace agreement in 2005 putting an end to the continent’s longest civil war. The peace agreement is formally referred to as “the Comprehensive Peace Agreement: CPA” and all political parties and other stakeholders were called upon to support it; it was, nevertheless, essentially a bilateral deal between the two military protagonists in the civil war: the then Sudan government of General Omar Al-Bashir, led by the National Congress Party (NCP) and the Sudan’s Peoples Liberation Movement/Army (SPLM/A), under the leadership of its late founding leader John Garang. In contrast to the limited role of national stakeholders other than the two main partners, the role of external actors has been decisive. Indeed, the agreement would not have been possible without the heavy regional and international efforts, most notably the Intergovernmental Authority on Development (IGAD) and the troika of Western donors—the so called friends of IGAD, which includes the USA, the UK, Norway and Italy.

The CPA is an elaborate agreement, comprising a number of protocols, including the Machakos Protocol on the “Declaration of Principles: DOD” (2002); Security Arrangements (2003); Wealth Sharing (2004); Power Sharing (2004); Resolution of the Conflict in Southern Kordofan and Blue Nile (2004); and Resolution of the Abyei Conflict (2004). There are also “Implementation Modalities” with time bound matrixes for all these protocols. Generally, the Protocols set forth the content of the CPA, thus describing what must be done. The Implementation Modalities set forth the details—they describe how things will be done by providing for the procedure, timing and responsible parties for each activity mandated by the Protocols. A number of commissions were set up to oversee the implementation of the agreement and to deal with left-over issues, such as reconciliation, human rights and land questions. In addition to laying the ground for peacefully resolving conflicts, power and wealth-sharing, governance institutions building and substantial foreign aid commitments from international partners, the CPA also calls for a self-determination referendum for the people of the south in early 2011 to decide on whether to partition the country or to keep it united, to be preceded by parliamentary, state and presidential elections in 2009.

The governance structure produced by the CPA is based on “a two-system, one country” formula for an interim period of six years. Therefore, under the CPA, a Government of National Unity (GNU) was formed, dominated by the NCP (52 percent) and the SPLM (28 percent) as well as a Government of South Sudan (GOSS), dominated by the latter; the Sudanese army of

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203 The Sudanese civil war had started in 1955, even before the full independence of the country one year later, and was interrupted by a ten year peace following the Addis Ababa Peace Agreement in 1972 between the military government of General Neimeri and the South Sudan Anyanya Rebel Movement, which granted South Sudan regional autonomy. However, this peace agreement collapsed in 1983, ushering in the second phase of the insurgency led by the Sudan’s People’s Liberation Movement/Army (SPLM/A); (for further review of the Sudanese civil war, see, for example, Ali, Elbadawi and El-Battahani (2005) and references cited therein).

204 IGAD is a regional development organization in East Africa, headquartered in the city of Djibouti. It was formed in 1986 and currently comprises of seven countries: Djibouti, Eritrea, Ethiopia, Kenya, Somalia, Sudan and Uganda.

205 However, more recently the Election Commission has decided to postpone the elections to April 2010.
the pre-CPA regime as well as the SPLA were allowed to co-exist as two separate armies; about 98 percent of the net revenues from the oil produced in the south is to be equally shared by the two governments, with 2 percent allocated to the producing states.

On the positive side, this arrangement has so far resulted in putting an end to the major historical civil war that immensely impacted the country, broadened the space for political freedoms and enhanced fiscal federalism and decentralization. This governance structure and the ensuing power and wealth-sharing associated with it appear to have resolved some important impediments to peace-building and averted a return to war, despite the acrimonious and often times conflictive relationship between the two partners: the NCP and the SPLM. The CPA has clearly offered an interim scheme for power and wealth divisibility that appears to have satisfied the two parties. The theoretical literature stresses the importance of “indivisibility” as an impediment to power-sharing (e.g. Milante and Skaperdas, 2009). Moreover, the referendum provides an “exit” option for the SPLM and the Southern Sudanese in the event that things went wrong from their perspectives.

In broad terms, the Comprehensive Peace Agreement (CPA) of 2005 and the Interim National Constitution (INC) marked a watershed in Sudan politics and since then the country has moved into a process of multiple transitions: from authoritarian, one-party rule to democratic, multi-party rule; from violent conflict to peace building- notwithstanding, of course, the unresolved conflict in Darfur and the residual tribal violence in the south; and from state-led to market-oriented, post-war economy. However, the country is currently facing a number of huge challenges in managing these transitions, which is made all the more difficult by its geo-politics endowment and significant oil reserves. Moreover, the focus of the CPA on the bilateral agenda of the two principals in the civil war has generated some serious undersides for the peace process, including that the partitioning of the country appears to be a distinct possibility; the prospects for democratic transformation remain precarious; while the ongoing conflict in Darfur constitutes a major setback to the peace process.

Few years following the CPA, doubts abound whether the process of transitions was making progress and whether the CPA will survive until the 2011 referendum on southern self-determination. In a curious way, by sending a clear signal that carrying arms is the only gateway to power and wealth-sharing, the CPA has not served as the stimulus to end the war and the humanitarian crisis in Darfur. Rather, it has fuelled it. Not surprisingly, therefore, progress on power-sharing, reconciliation between the people of north and south Sudan, and democratic reform have been sluggish and lukewarm at best. Indeed, the Government of National Unity (GNU), led by National Congress party (NCP) and Sudan People Liberation Movement (SPLM), is seen as not delivering and failing its commitment to “make unity attractive” and its promise to usher in a democratic transformation of the country. Post-war economic recovery and reconstruction have been frustrated by a plethora of factors, including security problems and political economy challenges, a major one of which is the steady growth of a crony capitalist class. As such, there was no peace dividend to show. Therefore, rather than serving as a model for peace agreements in Darfur and elsewhere in the country, the CPA and the broader peace process it fostered is at best stalling, or at worst is collapsing. So, instead of progress, all transitions in Sudan are in a state of “apparent” impasse.

206 The Sudan’s proven oil reserves is currently estimated at six billion barrels, which allows the country to produce 490 bpd, making it the third largest oil exporter in Sub-Saharan Africa after Nigeria and Angola.

207 This ramification of the civil war termination is probably unique to Sudan, as most civil wars that ended with a peace agreement did not generate perverse impetus for future wars.

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Section two discusses power and wealth-sharing arrangement and analyzes what went wrong with this central tenant of the CPA. Section three covers the inter-related themes of governance, democratic transformation and service delivery; this section also deals with fiscal policy and the revenue allocation commission and how it was preempted because it threatens the fiscal (and hence political) hegemony of the center (Khartoum as well as Juba). Section four addresses post-conflict economic development; and section five concludes—as well as offers some thoughts on the upcoming referendum of January 2011.

POWER SHARING: A STALLED AND UNCERTAIN PEACE

The grand vision of the CPA was best articulated by Dr. John Garang, the late leader of the SPLM, who envisaged a peace agreement that would eventually transform the politics and society into his vision of what he calls a “democratic new Sudan.” To articulate his views, he used what came to be known as the “Solution Modalities in the Sudan Conflict.” Dr. Garang argued that the pre-CPA Sudan was best reflected by Model 3 (of Figure 1), which was an “Islamic-Arab” state. The dual of this political order is a hypothetical Model 4 of an “Indigenous African Secular” Sudan. Both models, he argued, are not sustainable in the diverse Sudanese society. The main message conveyed by the two models was that the insistence by the ruling Northern Sudanese elites to maintain Model 3 was the reason why the Sudan has been so conflictive; but equally likely a “hypothetical” Model 4 would not bring peace to the country either. The ultimate goal, according to Dr. Garang, should be to transit to Model 1, which delivers the “transformed democratic new Sudan.” However, given the then military stalemate, the only route to Model 1 must be through an interim “three system administration” (Model 2). The modality for achieving this transition will be based upon the free choice of southern Sudanese through a referendum; the failure to create the right conditions for the new democratic Sudan will leave no option for the people of the South other than opting for the partitioning of the country (Model 5).

The challenge for the people of the Sudan, argued Garang, would be to scale-up the areas of communality during the interim period (the shaded area of Model 2) to span the whole political landscape of the country, leading to Model 1. Garang also used the security arrangement of the CPA to articulate the requirement of converging to Model 1 from this perspective. The CPA calls for the creation of joint/integrated military units (JIU) in both the north and south, which over time would constitute the new unified army under Model 1 (Figure 2). In our view, progress toward creating the JIUs should be an important benchmark for assessing the prospects for a peaceful unified Sudan or, at least, a cooperative and peaceful partition. Milante and Skaperdas (2009) build a model linking the commitment to power-sharing to the quality of the public goods that the adversaries view as their mutual investment in a shared future. Their model suggests that the quality of the power-sharing institutions is inversely related to “the number of armed each party has to maintain in reserve in order to continue enforcing the power-sharing agreement.” For the case of the Sudan peace agreement the JIUs should be the most visible kind of collective public good from the viewpoint of the NCP and the SPLM. The JIUs, therefore, can

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208 The eventual post-CPA governance structure turned out to be two rather than three-system, due to the objection of the NCP to having a northern entity.
209 The Joint Integrated Units (JIUs), a force of nearly 40,000 personnel, mandated by the CPA and intended to be formed out of equal number of troops from each of the Sudan Armed Forces (SAF) and the Sudan People’s Liberation Army (SPLA).
serve as a mechanism for building trust among the two armed groups. Therefore, the progress on the JIUs should be a critical benchmark for assessing the success of the CPA, especially with regard to the objective of “making unity attractive.” Alternatively, the process of national reconciliation could have contributed to creating a much needed trust between the two partners to make up for a weakened role by principal peace drivers among the leadership of both NCP and SPLM.

Unfortunately, while both partners were engaged on an apparent arms race (Elbadawi et al, 2008) during the past six years the formation of the JIUs has not been a matter of high priority and has fallen behind schedule. This makes clear that the two partners do not see much scope for “a mutual investment in a shared future.”

As we will discuss below, the CPA has offered a grand vision of inclusiveness and democratic transitions. This has, however, been confined to the broad principles, while the modalities of power and wealth-sharing have effectively disenfranchised the rest of the political forces in the center and the south alike, and radicalized other stakeholders in the periphery (Darfur). Despite formal structures of power and a wealth-sharing arrangement, real power remained a monopoly of the incumbent parties, the NCP and to a lesser extent the SPLM.

**The Government of National Unity**

A government representing NCP, SPLM and Northern and Southern political parties, mostly small and splinter parties allied with the NCP, was formed in 2005 to lead the country through the transition process. However, realizing that this government will be substantially dominated by the NCP and that they will not have representation even remotely commensurate with their perceived popular following, the two major opposition parties in the North, the Umma Party (UP) and People’s Congress Party (PCP) did not join the government or the National Council (Parliament); while the Communist and the Democratic Unionist maintained nominal representation at the Parliament. The formula of representation adopted by the warring parties, NCP and SPLM, and accepted by IGAD and international community at the peace talks was based on giving the NCP a clear majority in both the government and parliament: NCP 52 percent; SPLM 28 percent; Northern Parties 14 percent and Southern Parties 6 percent. Armed with a clear-cut majority in all governance institutions (executive, legislative, judiciary and civil service), the NCP wasted no time to further disorganize Northern opposition parties and support non-SPLM groups in Southern Sudan, thus effectively squashing any hopes for a change in government as a result of the power-sharing agreement.

A fuller discussion of the role of the National Council in legislation and as a watch-dog over the government performance is beyond the scope of this paper. However, it suffices to say that the performance of the Council and its Speaker was a major cause of contention between the two partners (NCP and SPLM). MPs representing the latter walked out from Parliament more than once in protest against the way sessions were orchestrated, agenda-setting and stage-managed deliberations and legislations. The hegemony of the two ruling parties, especially the NCP, on the legislature was also extended to the other legislative chamber of the States’ Council, which exists to provide an independent voice for the 25 Sudanese states (two representatives for each state).

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210 In the last multi-party democratic elections in 1986, before the military takeover in 1989, the Umma Party and the DUP won elections and dominated the 252 member Parliament with 100 seats for Umma and 68 for the DUP.
It must be stressed here that it was not only the hegemony of the two ruling parties on the executive branch of the government and the legislature that militated against democratic transformation during the interim CPA era; almost no state institutions, including the civil service, public economic corporations, universities, judiciary and the police, were restructured in terms of policy environment, organizational set-up and manpower in line with the CPA. The envisaged democratic transformation that was hoped to be inspired by the CPA leading into the vital April polls was premised on the transformation of these institutions into genuinely national ones after 20 years of absolute NCP rule.

Unfortunately, this cherished CPA goal has proved to be extremely difficult to achieve. As we will argue below, by and large this outcome should be attributed to nothing other than its bilateral nature, which allowed the NCP to maintain the status quo, especially in the north.

What Went Wrong?

From the beginning, external actors took over the task of resolving North-South conflict and managing the peace process leading to the CPA in 2005. The CPA has, therefore, reflected their emphasis on maximizing the immediate success of getting the two military parties to the conflict to sign the peace agreement. This required that the CPA caters for three considerations: (i) a power and wealth-sharing arrangement that allows the two parties almost exclusive (and divisible) control over power and wealth, most notably oil wealth, during the six years of the interim period; (ii) a commitment technology through the maintenance of the two separate armies, which allowed both parties to retain their coercive powers; and (iii) a potential exit strategy for the South through the self determination referendum.

While it might not be surprising that the two Sudanese adversaries would favor such a peace process, it is rather unfortunate that the external actors ignored the Sudanese democratic legacy that survived three long autocratic regimes, including the pre-CPA Salvation regime of General Omer al-Bashir. The country inherited the tradition of Westminster democracy from British colonialism, whereby the first post-colonial government was an elected parliamentary democracy (1956-58), which was subsequently deposed by a military coup. However, and despite the civil war and the interruptions by the military coups, there were two further periods of democratic rule (1964-69 and 1986-89). In both cases, the democratic governments were swept to power following popular uprisings that deposed the military and led to multi-party elections. This, we will argue, is a testimony of the authenticity of the democratic legacy in the country. Indeed, compared to most countries emerging out of conflict, it is a unique characteristic of Sudan that could have been a positive agent of peace and democratization had it been included in the design of the CPA. This, in our view, is a major omission in the light of the long and acrimonious history of animosity associated with the Sudanese civil war and the lack of trust between the two opposing parties. If given a seat in the table and some role in the post-CPA political order, other Sudanese political parties and civil society organizations would have contributed to bridging the political distance between the two principals as well as exert strong internal pressure for democratization and unity. Admittedly, however, this would have complicated the peace process and could have delayed the eventual conclusion of the CPA; but it would have eliminated or substantially moderated the hegemony of the two ruling parties on the post-CPA interim government and state institutions. This, as is widely believed by most Sudanese scholars, could have significantly increased the likelihood of democratic transformation, unity and the resolution of the Darfur conflict.
However, contrary to traditional African approaches to resolving conflicts which emphasize building trust, the Sudan peace process made no explicit attempt to build trust between the parties to the conflict, either during the formal negotiations or in the post-CPA period. Indeed, the peace process was shaped by Anglo-American legal culture, where law and legal procedures are emphasized. Reflecting the dominant view of the CPA partners and its external architects, one SPLM negotiator simply dismissed “trust” as not necessary to reach an agreement (Young, 2007). Seemingly every issue and contingency is identified and catered for in the protocols and the result is a massive and complex agreement, which is hard to understand and its implementation is extremely difficult to assess. Within the Anglo-American legal culture, alleged breaches of an agreement are referred to accepted judicial bodies which have both the capacity to rule on the complaints and to order policing authorities to ensure that rulings are implemented. However, no such accepted judicial organs or police exist in Sudan and hence the resort to this sophisticated legal culture in the absence of trust has largely proved ineffective.

The CPA has not enshrined principles of democratic transformation as part of its text; instead, democratic reform is envisaged as a by-product of the agreement. Reform and democratic accountability were to be achieved through national elections, yet this is doubtful since the CPA does not offer concrete modalities for leveling the playing field in order to ensure truly competitive and fair election. According to Special Envoy Sumbeiywo, “after three years, all the parties will get the chance to compete for power through the electoral process” (quoted in Potter, 2006). Although the US consistently opposed a broadening of the peace process that would give it democratic legitimacy, it nonetheless repeatedly—and contradictorily—emphasized its support for a democratic transformation in Sudan based on free and fair elections. The US conflict resolution and peace-building strategy in Sudan has focused on government and the rebel forces (in North, South and Darfur), one result of which was the severing of the peace-building process from democratic transformation (e.g. Ahmed and Elbadawi, 2009). But even setting aside the limited nature of the political opening, from its inception, the notion of elections being a crucial means for the Sudanese people to pass judgment on the peace process has been problematic at best, and disingenuous at worst. The recent April 2010 elections, which are widely considered to be fundamentally flawed and widely manipulated by the two ruling parties, attest to this assessment. The proceedings showed very little tolerance for democratic opposition; and moreover, the elections were presided over by an indicted head of state by the International Criminal Court (ICC) over crimes against humanity in Darfur. All these factors clearly left very little to no room for the incumbent ruler to allow an open but risky democratic process that might very well result in his being voted out of office.

A further difficulty arises because the GNU-dominated National Assembly passed legislation in early 2007 that precludes parties from contesting the election unless they support the CPA. This undermines the Sudanese people the ability to express their views on the peace agreement. While almost all parties in the country endorsed the broad thrust of the CPA, many in the Umma and DUP have argued that the agreement touched upon areas beyond its remit. But under the Political Parties Law, political parties which do not accept the country’s constitution, which is based on the CPA, can be dissolved. It is not difficult to appreciate the concerns of the

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211 The adoption of such legal culture by the NCP and the SPLM could also be interpreted as a self-serving instrument for carving out and dividing power among themselves and not really a matter of cultural transformation on their part.

212 See, for example, the report of the Sudanese April 2010 elections by the Carter Center (www.emory.edu/CARTER_CENTER) as well as the one by the European Union.
SPLM/A that a party or parties could come to power in Khartoum that did not accept the CPA, and that this could lead to the collapse of the peace process and even a return to war. But the legislation is undemocratic by any standard and demonstrates a distrust of the people of Sudan, a distrust that was a constant theme of the negotiating process.

However, it is important to acknowledge that this is a complex issue that reflects the fact that post-conflict democratization must be predicated on the imperatives of peace-building, and that this type of restricted democratization has not been confined to Sudan.

There is also a perceptual difference at work between approaches which largely concentrate on the surface, reject historical and political analysis and have a utilitarian focus, and what could be called historical-political approaches, which point to the need for a deeper analysis and aspire to understanding the nature of the problem, placing it in context, and achieving a sustainable peace. Although not a perfect comparison, the Declaration of Principles (DoP) agreed to by the NCP and the SPLM, which predates the CPA, had offered a “deeper analysis” in the words of Sumbeiywo, while the Machakos Protocol of the CPA was functional, problem-solving, and geared to meeting the key needs of the negotiating teams. This latter approach did not consider whether the adopted solutions would overcome the problems which produced the conflict in the first place, and did not attempt to reach a sustainable or comprehensive peace, despite rhetoric to the contrary. The problems that bedevilled Sudan since its formation as an independent state213 were simply reduced to arising from groups using violence to struggle for power, and hence the task of the peace makers involved reaching agreements between the two groups at the negotiating table to stop the fighting. Not surprisingly, two SPLM respondents referred to the CPA as in effect “an extended cease-fire.” A third described it as “temporary agreement” (Young: 2007).

Another problem with the Naivasha mediation is that it was inconsistent, using tools and approaches designed to affect immediate changes and end the violence, while ascribing to objectives like “making unity attractive” and democratic change that could only be realised in the long-term and that involved structural change and transforming relationships and attitudes. Thus far from achieving democracy, the major impact of the peace process was to reinforce the power of the state and those groups that dominated it by effectively guaranteeing their existence for the six and one half years of the peace agreement. The objective of the mediation then was largely reduced to finding space in the state at the centre for the SPLM/A and creating a state in the south. However, by reinforcing the power of the state and its exploitive relationship with the peripheries, including the south, the mediation undermined its other stated objective of making unity attractive.

And by not engaging Sudanese civil society and failing to make the Sudanese people feel part of the peace process, the IGAD mediation had the unanticipated and wholly unconstructive effect of giving life to the top-down, illegitimate, and no longer viable political culture of the country. This is particularly apparent in the north, where the leading parties, the Umma Party and the DUP, are still suffering from their poor performance in the 1986-89 coalition government and its failure.

GOVERNANCE, DEMOCRATIC TRANSFORMATION AND SERVICE DELIVERY

213 For a historical overview of the anatomy of the Sudanese conflicts, see Ali, Elbadawi and El-Battahani (2005) and references cited therein.
There is now a wide consensus that the efficiency, quality and equity of service delivery are inextricably linked to accountability, voice and democratization. As such, service delivery is no longer a top down bureaucratic operation, but a deeply political process. In the context of post-CPA Sudan, democratic transformation and social service delivery were both driven by the process of power and wealth-sharing in the CPA agreement.

**Governance and Democratic Transformation**

The CPA accorded the NCP and the SPLM almost total control of the organs of power in the country. Ample evidence can be marshaled to corroborate the view that the NCP has effectively used its CPA-mandated control over the North to disenfranchise the major political parties in the north. With complicity of external actors, the NCP resisted all efforts by the political opposition, especially the Umma Party, to adopt a comprehensive approach to the Darfur problem in a context of a national all party-all stakeholders conference. The piecemeal approach to the resolution of the Sudanese conflicts is an unfortunate legacy of the CPA that has proved to be ineffective for making peace in Darfur and may very well lead to renewed conflicts.

Despite its solidarity with the northern opposition forces with regard to the issues of elections, the democratic credentials of the SPLM as the party in power in the south leave a lot to be desired. Having seen NCP not objecting to simple majority self-determination in the referendum vote, the position of the SPLM and external actors in the peace process (most notably the US) was visibly less forceful with regard to the National Security Law, where the NCP took an unwavering stand and was able to force a bill that invests security agencies with substantial powers. This is despite the fact that both the political opposition and the SPLM argue forcefully that the version that the NCP was able to pass in Parliament constitutes a serious threat to political freedoms and the envisaged elections.

The failure of the CPA to anticipate the need for a neutral transitional government to oversee the elections and the referendum might have endangered the legitimacy of this defining milestone for the country and people of Sudan. According to the opposition forces in both North and South, the incumbent partners, especially the NCP, have abused their control of the government in an attempt to influence the elections. Moreover, the increasing oil dependency of the country and the control of the incumbent partners of the oil revenues is another impediment to democratization in post-conflict Sudan.

As discussed earlier, Sudan has a legacy of democratic rule (1956-58, 1964-69, 1985-89) which, despite its brief nature and the civil war, had afforded the country a decent degree of political competition and political rights. According to one popular measure of political competition (Polity IV) and another one on political rights (the Gastil Index), Sudan substantially outperformed the median country in SSA during these periods (Figures 4 and 5). However, following the coup in 1989, Sudan became a restricted, factional authoritarian state according to the Polity IV dataset. This lasted until recently when it graduated to a restricted competition state since 2002, reflecting the slightly diminishing capacity of the NCP and the SPLM to control political opposition. However, and despite the country’s notable democratic legacy and the peace agreement the post-CPA regime was still very authoritarian. A comparison with the median

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214It is pertinent to note that, as a national political party, the Umma party has carried the Darfur region in the last democratic election in 1986 and is likely to still have a measure of popular support in the region.
Africa country will show that no real progress has actually been made. As noted by Elbadawi et al (2008),

“despite having identical polity scores in 1989 and 1990, the democratization path for Sub-Saharan Africa diverged over the 1990s and a sizeable gap of approximately 8 points in polity remains between Sudan and the median African state. The divergence in democratization is also apparent in the measure of political rights compiled by Freedom House. Despite similar levels of political rights in the late 1980s and early 1990s, political progress in sub-Saharan Africa has resulted in the median SSA country being termed “partially free.” Meanwhile, the people of Sudan are considered “Not Free” by the Freedom House index of political rights.”

However, notwithstanding the disappointing progress on democratization during the post-CPA interim period, we would like to ask two pivotal questions, since it is envisaged that the country is on course to having multi-layer elections: what are the chances that the envisaged elections would lead to genuine transition to democratic rule; and what are the chances that these elections will be fair?

Political theorists, from Machiavelli to Huntington, have dismissed the possibility of popular government arising out of the chaos of civil war, instead prescribing an intermediate stage of one-man/(person) rule by a Prince, Leviathan, or a military dictator. However, based on recent empirical evidence of post-civil war democratization in El Salvador, Mozambique, and elsewhere, the modern political science literature undertook the task of building theoretical models for explaining how democracy can arise directly from anarchy. For example, Wantcheckon (2004) builds a model to analyze two pivotal questions: why would militarize groups agree to democratize?; and why would they defer to the citizenry the role of deciding which faction has control over the government? The model assumes that the “predatory” warring factions choose the citizenry and democratic procedures over a Leviathan when (i) their economic interests depend on productive investment by the citizens, (ii) citizens’ political preferences ensure that power allocation will be less biased under democracy than under a Leviathan, and (iii) there is an external agency (e.g., the United Nations) that mediates and supervises joint disarmament and state-building.

However, the key assumption (i) is likely to be violated in the case of the Sudan because the warring factions’ payoffs depend largely on their control of the oil rather than on the productive investment made by the residents of the country, an investment that generates a positive externality in the model. In this case, the residents’ investment has very limited effect on the warring factions’ political decisions. This perhaps explains the key difference between civil wars that do result in democracy (e.g., in Mozambique and El Salvador) and civil wars that do not (Sierra Leone, Angola). Hence the main implication of this model was that democratization is less likely when the factions depend heavily on foreign aid or natural resource wealth.

And on the related issue of whether the initial political conditions in the Sudan inspires confidence that the powers that be (the SPLM and, especially, the NCP) would refrain from illicit electoral tactics, the received literature might also offer some useful guidance. Collier and Hoeffler (2009) proposed a simple theoretical model on the incentive for the incumbent for...
resorting to illicit tactics and what type of deterrents are likely to be most effective against this practice. They find that illicit tactics have been highly effective in increasing the chances of winning elections by the incumbent. Their evidence also suggests that small, low-income and resource-rich societies have little chance of clean elections. They further find that economic growth and welfare are not likely to attain high priority in societies that are prone to illicit electoral tactics. Indeed, the predictions of this theory seem to augur well with the alleged irregularities that most external observers believe have afflicted the recent CPA-mandated elections, if not the outright election rigging by the NCP as claimed by the Sudanese opposition. The implications of this finding for Sudan are depressing, given the prevailing conditions during the post-CPA interim period, most notably the increasing dependence on oil, and the impotence or lack of will by the international actors in the peace process to rein in the two partners on the issues of corruption and political and human rights. Another ominous sign that might be linked, according to the literature, to lack of interest by the two incumbent partners to work for winning the broad electorate through a licit electoral process is their dismal record on social service delivery. We turn next to this issue.

**Social Service Delivery**

Overhauling social service delivery and ensuring its adequacy, quality and equity, especially for marginalized regions and communities has emerged as the centerpiece of the post-CPA poverty reduction strategy (PRSP) of the new Government of National Unity. Like in most post-conflict countries, the human development crisis is a direct effect of conflict but is also a major cause of future conflicts. However, the arms race precipitated by the dynamics of the bilateral power and wealth-sharing polity meant that the states continue to be burdened with the substantially underfunded mandate of providing for social services. The lack of commitment on the part of the two partners was also manifested in the undermining of the nascent Fiscal Financial Allocation and Monitoring Commission (FFAMC), which was constituted as part of the CPA and mandated by the Interim National Constitution (INC) to oversee the inter-governmental fiscal transfers and to ensure that they are adequate, equitable and transparent.

**The Human Development Crisis**

Beside conflicts, the other side of the underdevelopment trap that impacted the Sudan is manifest in widespread poverty and deprivation. According to some recent surveys, pertaining to the 1990s, about 60-75 percent of the population in North Sudan is estimated to be below the US$1 a day income threshold, while estimates for South Sudan are around 90 percent poverty. Moreover, poverty mirrored in a variety of human development indicators. Despite the sustained growth
since the second half of the 1990s, most experts believe that poverty remained widespread and that it has actually increased and not declined during this period. These estimates appear remarkably consistent with indirect evidence on the dynamics of poverty in the 1990s due to Ali (2003). Professor Ali’s analysis hinges on contrasting the relative influences of consumption growth and inequality as the two key determinants of poverty. He finds that, as expected in a growing economy, per capita consumption grew (at rates ranging between 1.6 to 2.8 percent), while inequality worsened at a much higher rate (4.5 percent). Due to the much higher influence of inequality than consumption growth, poverty has risen during the 1990s, despite the relatively high growth during the second half of the 1990s. Simply put, the growth of the second half of the 1990s has been too regressive, to the extent that it was associated with rising and not declining poverty.

Corroborating these aggregate findings with evidence from sectoral growth might help explain why the 1990s growth has been so regressive. Several pieces of evidence can be cited from the traditional agricultural sector. This sector grew very fast during the period, at annual growth rates of 20 percent for crops and 10 percent for livestock. However, it has in fact only managed to achieve a rebound from the steep decline of earlier drought-stricken decades. Moreover, even during years of high growth, the contribution to the economy of the traditional agricultural sector (as high as it may be) has always been lower than its share of the population. For example, it is estimated that while the traditional rain-fed sector contributed 56 percent of the agricultural GDP in 1999, it supported about 77 percent of the population. The irrigated and rain-fed mechanized sub-sectors have, respectively, contributed 22 and 7 percent of agricultural GDP, but have supported only 12 and 0.7 percent of the population (World Bank, 2003). As noted by this World Bank report (p. 36), “Clearly, there is a skewed distribution of income from an aggregate agricultural growth that is quite substantial.” Therefore, low productivity in the traditional agricultural sector and high inequality within the wider agricultural sector suggests that despite the high overall agricultural growth, rural poverty is likely to be persistent.

The rise in urban poverty is also caused by high inequality as well as low productivity due to the informalization of the urban economy during the 1990s, especially in the capital city, which now accounts for more than one quarter of the entire population of the country. A partial picture of urban inequality is reflected by the evidence from labor surveys, which suggests that the top 10 percent receiving salaried income accounted for 51.6 percent of all earnings in 1990 and 64.3 percent in 1996.

In terms of the overall human development situations, recent estimates suggest that Sudan’s human development rankings (education, health, social infrastructure) was very low at 141 (out of 177 countries) on the country list (UNDP, 2006). It is also significantly lagging behind the average for Sub-Saharan Africa (World Bank, 2003). Taking into account that Sub-Saharan Africa is experiencing a human development crisis makes clear the extent of the tragic collapse of human development in Sudan. The following is a summary of the status of the main human development indicators in Sudan and the gap relative to the MDG targets:

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area from Khartoum through the Gezira to Gadaref in the Eastern Sudan, widespread poverty is common to almost all other areas (Southern Sudan not covered).

218 For example, the total volume of sorghum production during 1995/96-1999/00 (at 858,000 metric tones) was approximately equal to the volume produced in 1977/78-1981/82 (World Bank, 2003).

219 These estimates are reported in Fageer and Merghany et al (2002).

220 A detailed analysis of the human development crisis in Sudan is provided in chapter 5 on basic social services of the Sudan’s Joint Assessment Mission report (World Bank, 2005).
1. High incidence of poverty (ranging between 50-90 percent), especially in the South;
2. Acute and chronic malnutrition, estimated at about 35 percent in the North and 48 percent in the South;
3. All MDG indicators show inequalities in gender, rural-urban divide, North-South;
4. High incidence of child and infant mortality, infectious diseases, and rising rates of HIV/AIDS (2.6 percent).

Moreover, these national figures also mask stark regional differences for all human development indicators. It was never disputed in Sudan that the levels between urban (i.e. Khartoum) and rural areas, in particular the South, were high. Arguably, these differences are the basic reason behind Sudan’s civil conflicts (see Seekers of Truth and Justice 2004). However, there have never been hard data about scale and nature of these differences. The World Bank-UNDP Joint Assessment Mission for the Sudan (JAM) in 2005 was the first to put data together (Figure 6).

Sudan’s Household Health Survey (SHHS) of 2006 is the first nationally integrated data set by state that covers a number of MDG indicators. The following two figures (Figure 7 and 8), respectively, show state level net primary school attendance (as a proxy for literacy) and birth attendance by skilled health personnel (as a proxy for life expectancy). Two facts are very clear from the first figure: first, there are indeed stark differences between states. Within the North, Western and Eastern states are doing worst and in the South, the central Equatoria states are doing much better than the more peripheral states Secondly, all of the Northern states are doing better than the Southern states (Hansohm, 2007). The health results are not so strongly

Moreover, the evidence from post-CPA Sudan seems to corroborate the view about the centrality of politics to social service delivery. The conventional view of effective and efficient delivery is perceived by practitioners and policy makers as being a politically neutral and technical solution to poor policy implementation. However, while the service delivery processes are apparently technical or managerial, they are in fact deeply political, as they define a power relationship between the state and its citizens. According to McLennan (2007), a proper conceptualization of delivery processes requires highlighting the politics of the process. For example, social service delivery in Sudan is relying on a mixture of private and public-run bodies, as well as on contracting out services. With the public sector almost totally withdrawn, investment in the unregulated health and education is now a prime area for private business in Khartoum and other major cities, where major rents are reaped by the private network of service providers (Awad, 1998; Muneef Abdelbagi: 2004). This concept of social service delivery could be linked to macroeconomic policy aimed at facilitating growth with minimal state intervention and reduced social cost. It assumed that more efficient delivery would enable markets to thrive, standards of living to increase, states to address needs appropriately and people to have a broader range of choices of services. The intention was to redirect government away from a concept of universal service delivery facilitated by the bureaucracy to a concept of demand-driven delivery facilitated by the market. This delivery system benefits those in the strongest position to exercise market choice. Poor people have little or no leverage and contracted service providers have little reason to consult them (McLennan, 2007).

Clearly this service delivery strategy is not consistent with the overarching objective of reducing the risk of post-conflict war relapse through more equitable growth and social service delivery. However, the ruling NCP government has embraced this approach to service delivery simply because the priorities of the state resource allocation are captured by the arms race and
the need to maintain the allegiance of the military-security power base. The 2010 budget referred to above is an epitome of how political economy considerations have played out in terms of the resource allocation decisions under the CPA government.

Social Service Delivery and Fiscal Decentralization

Fiscal decentralization was supposed to be the backbone of social service delivery, which was assigned to states and local government authorities. Given that most sub-national levels of government in Sudan have little capacity to raise revenues to meet the requirements of their expanded mandates in this area, the grant allocation system from the federal government emerged as the most critical institutions since the early 1990s, especially after the production and exporting of oil in 1998. The body that managed this system prior to the CPA was the National State Support Fund (NSSF). However, an analysis of these transfers for the 2005 budget finds that the aggregate vertical transfers had barely met states’ needs, given their own revenue mobilization potentials. Moreover, the implementation of the system was not found to be consistent with the declared objectives of horizontal equity across states (Elbadawi and Suliman, 2007). For example, when ranking states by population density, share of rural population and share of children in the 0-14 age group, these authors fail to find systematic relationship between the transfers per capita and any of the three factors. Based on the NSSF own allocation criteria, states with higher rural population, larger share of dependent children, or lower population density should receive more transfers. However, NSSF had violated these criteria in several cases. Thus, should have the proposed formula been properly implemented, the emerging architecture of the transfers will have been radically different from the actual in 2005 (Figure 9).

After the peace agreement, the Fiscal, Financial Allocation and Monitoring Commission (FFAMC) was established with a very substantial mandate on issues of fiscal federalism. Moreover, a highly respected and independent-minded former Minister of Finance (Mr. Ibrahim Moneim Mansur) was appointed by consensus by the two partners (the NCP and the SPLM) to lead the Commission. However, perhaps realizing the potential implication of this CPA-mandated body for their ability to engage in discretionary and unregulated fiscal policy, the new incumbent partners singled out the FFAMC to be the only CPA-mandated commission to have its head and board of advisors to be appointed by a “Presidential Decree” rather than an “Act of Parliament.” The FFAMC and its advisory board wasted no time and moved on to develop an objective and coherent framework for determining the required vertical and horizontal transfers. While this task was very technical, the Commission under its founding leadership had shown considerable awareness about the political context under which it had to operate. Therefore, it did not refrain from playing an active advocacy role for promoting knowledge and drawing lessons from other countries about the political requirements for successful fiscal decentralization as well as the consequences of the latter for the political process in the country. The first budget that was developed according to explicit and measurable criteria and was carefully negotiated with the states and the Federal Ministry of Finance was for FY 2006. However, in contravention of the CPA and the Interim National Constitution (INC), the now dysfunctional NSSF started to interfere with the process, which promoted the head of the FFAMC to threaten to take the issue to the Constitutional Court. However, the two incumbent partners unceremoniously dismissed the founding head of the Commission and dissolved its advisory board and appointed none other than the chairman of the NSSF as the new head.
The story of the FFAMC is consistent with the overall analysis of the political economy of resource allocation and its responsiveness to the implications of the referendum, oil and the associated arms race between the two incumbent partners; the conflicts in Darfur and the residual tribal violence in the South; and even more importantly that the two partners are essentially military organizations that see their survival in power as dependent on their respective security-military apparatus. Moreover, the CPA-mandated monopoly on power and oil revenues made it possible for them to finance their expensive power base. Needless to say, this political calculus is likely to have grave consequences for the country, which is another issue that the external architects of the CPA should not have underestimated.

MACROECONOMIC POLICY AND POST-CONFLICT RECONSTRUCTION

Countries coming out of conflicts have large needs, both humanitarian and developmental. For virtually all post-conflict countries, aid is the central element of post-conflict reconstruction and peace consolidation. And, because of the huge potential for catch-up growth in these countries, their economies tend to have high absorptive capacities and aid can be highly effective, even with modest improvements in the institutional and policy environment. This has been among the most robust findings of the literature, which is also borne out by the experience of post-conflict Africa for the first six years or so after the end of civil wars. For example, a median country would rebound from negative per capita growth rate of about -1 percent in the year before peace onset to more than 2 percent in the second year; and despite the high volatility across countries, the average median growth hovered around 2.5 percent up to the sixth year before decelerating to around 0.1 percent thereafter (Figure 10).

Post-conflict Sudan, however, has not been a typical case because oil rather than aid has been the centerpiece of the post-conflict growth strategy. The last ten years since 1999, when Sudan exported its first shipment of oil, have earmarked a major transition of the Sudanese economy. Nominal GDP has grown fivefold from US$10 billion in 1999 to US$55 billion in 2008, and real (PPP-adjusted) per capita GDP increased from less than US$1,500 to more than US$2,500 (Figure 11). Moreover, oil resources allowed the consolidation of the earlier macroeconomic stabilization programs that preceded the oil era. Inflation was brought from the staggering rates of more than 120 percent to about 40 percent by 1996, but it took significant oil revenues before the government could decisively bring down inflation to single digit levels.

However, the Sudan oil-driven growth is not likely to be sustainable, due to a variety of political and economic factors. First, growth has been almost exclusively oil driven, which is manifest in the dominant role of oil in the economy, where it accounts for more than 90 percent of exports and 60 percent of fiscal revenues. For the south, oil constitutes a staggering 98 percent of the GOSS public revenues. Unfortunately, if anything, after ten years of producing and exporting oil, Sudan has all but lost its comparative advantage in agriculture, while its nascent industrial sector is no longer competitive (World Bank, 2009). Indeed, given the deterioration in its deep structural economic and political indicators, the Sudan may eventually experience an “oil curse.”221 One relevant indicator is that the Sudanese economy has failed to generate enough replacement human and physical capital as oil resources are being depleted. Recent World Bank evidence suggests that, among several oil and mineral producing countries, Sudan has

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221 An oil curse is associated with an absolute decline in output in the aftermath of an oil boom. Unfortunately, the literature suggests that most economies experience post-boom growth collapse, and that success in turning oil booms into sustainable diversified growth has been the exception to the rule (Elbadawi, 2009).
experienced negative “genuine” savings (Figure 12). Another sign of an eventual oil curse is deteriorating economic governance, as reflected in three aspects of macroeconomic and institutional performance indicators.

First, the economy has recently experienced large external imbalances, high accumulation of debt and real exchange rate overvaluations, which substantially undermined the competitiveness of non-oil tradable sectors (Figure 11). Second, fiscal policy has been lax and very volatile, reflecting the pro-cyclicality to the oil sector. For example, at the height of the oil price boom in 2008, the federal government overspent the oil revenues and ran a large fiscal deficit that required further accumulation of domestic arrears and new external debt, while the GOSS spent more than US$2 billion in the same year, which had to be drastically reduced in 2009 (World Bank, 2009). Third, the deteriorating standards of economic management in the country are reflected by the very low score (-1.66) achieved by Sudan in a popular World Bank index of economic governance for 2008 (Table 2). This index accounts for six aspects of economic management (voice and accountability; political stability; government effectiveness; regulatory quality; rule of law; control of corruption) and ranges from -2.5 (worst performance) to 2.5 (best performance). Sudan’s dismal score on this index coheres with the direct evidence on the high unit cost of civil construction; extremely high level of nonperforming loans (NPLs) in the banking sector; excessive costs and time overruns in public infrastructure projects; or the lack of serious and open debates on major public sector outlays, such as irrigation dams and other infrastructural projects. These are all symptoms of unaccountable but also inefficient economic governance.

Moreover, the growth has been inequitable and has further reinforced the historical marginalization of some regions in the north that have been ripe for conflicts, such as Darfur and the East, while the south remains one of the most impoverished regions in the World as the available data on the MDGs suggests. The following comparisons from a recent World Bank (2009: p. 5) report highlight some stark contrasts:

“For example, in 2006 the net attendance rate in primary schools in the best performing state was 91 percent, while in the worst performing state it was 4 percent Sudan’s capital city consumes nearly a third of the electricity in the country, while less than 7 percent of the household in the country have access to the national grid There are eight bridges over the river Nile around the Khartoum city, while the remaining 1500 kilometer stretch of the river has only eight such bridges, and only one in Southern Sudan.”

These statistics illustrate the persistence of wide regional and ethnic disparities within the country that, as the civil war literature suggests, are likely to have been among the main factors behind the wars in the South and the current one in Darfur. These horizontal inequities are also the main reason why Sudan may, unfortunately, be vulnerable to yet more conflicts in the future.

It has been argued that sustaining growth in post-conflict countries and elsewhere requires sustainability of growth-oriented policy, which in turn cannot be secured without a

222Simply put, a country will experience a real currency overvaluation (undervaluation) when it produces a given basket of goods and services that can be traded across international borders at a higher (lower) cost than what would be consistent with its sustainable economic fundamentals – such as the external terms of trade; the level of sophistication of its economy or the stock of wealth generated by or endowed with the economy. Moreover, real exchange rate (real currency) undervaluation (overvaluation) is consistent with higher price of tradables relative to non-traded domestic goods and services.
stable institution for mediating inter-ethnic contests, especially in economies susceptible to external shocks (e.g. Rodrik, 1999). The quest for extending the growth spells in post-conflict countries long enough to allow the reduction of post-conflict risks to relatively safe levels have occupied recent research and policy efforts. Thus the new policy-plus agenda has focused on the quality of institutions for managing aid, especially with regard to infrastructure and the delivery of social services. Moreover, and due to the high share of oil and other mineral exporting countries among post-conflict countries, the literature has also focused on management of commodity booms and institutions for ensuring the fairness and transparency of granting minerals and oil concessions (e.g. Collier and Goderis, 2009; Humphreys et al, 2007). Weak institutional capacity and lack of political openness and inclusion, therefore, constitutes the weakest link in the sustainability of post-conflict growth in Sudan.

Unemployment

The size of the labor force in 2008 was estimated at 16.6 million persons and the rate of unemployment was 19.7 percent (see table below). The sectoral distribution of employees reveals that most of them are agricultural workers (53 percent) with the services sector (20%) forming the second-largest source of employment. The industrial employees and transport amount to 7 percent and construction sector employees represent 3 percent.

<table>
<thead>
<tr>
<th>Year</th>
<th>1996 (actual)</th>
<th>2007 (actual)</th>
<th>2008 (estimated)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor force</td>
<td>8.2</td>
<td>11.2</td>
<td>11.6</td>
</tr>
<tr>
<td>Employees</td>
<td>6.9</td>
<td>8.9</td>
<td>9.3</td>
</tr>
<tr>
<td>Unemployed</td>
<td>1.3</td>
<td>2.3</td>
<td>2.3</td>
</tr>
<tr>
<td>Rate of unemployment (%)</td>
<td>16.6</td>
<td>19.4</td>
<td>19.7</td>
</tr>
</tbody>
</table>


According to the available statistics, the rate of unemployment increased from 16.6 percent in 1996 to 19.7 percent in 2008, which is an increase of 3.1 percentage points. In general, the trend of unemployment is rising, while demand for labour continued to increase by 3.3 percent and demand for employment opportunities increased by 2.6 percent or less than that (ElJack and Abd-Elwahab: 2010). Expansion in the oil sector did little to alleviate the negative employment impact of the job-less growth the Sudan economy experienced during the last decade.

Within the Sudan labour market and the growth economy, the informal sector is continuously growing and expanding. The informal sector provided 50,000 to 60,000 jobs in the Khartoum urban area. This is equivalent to 50 percent of modern urban sector employment. The rate of increase of employment in the informal sector is estimated in a range of 5 to 7 percent. The informal sector is expected to grow by 75 percent during the coming ten years and this generates an additional 40,000 to 50,000 jobs (ElJack and Abd-Elwahab: 2010).

Higher education grew by 400 percent during the last two decades. The number of graduates increased to 50,000 annually. The extension of high education is not in balance with economic growth and the demands of the labour market. The impact of unemployment is severe among youth who enter the labour market for the first time, particularly educated youth and
women. The information available reveals that unemployment among graduates is about 49 percent. The gender distribution shows that unemployment is higher among females (38 percent) than males (22 percent) (ElJack and Abd-Elwahab: 2010).

Risk of GOSS Dependency on Oil

Fluctuation in oil production resulted in inconsistent direct transfers to the GOSS. For example, from January to December 2006, transfers to GOSS amounted to US$945.94 million, but the transfer of oil revenues to the GOSS fell in March 2006 to US$44 million from more than US$90 million just a few months earlier (International, Crisis Group, 2007).

Given this trend, GOSS has not yet legislated and introduced tax laws in addition to receiving oil revenue shares. The 50 percent oil revenues and transfers to the GoSS only meet current spending. Current expenditure consists of salaries, wages and recurrent services such as fuel etc. These have affected the GOSS pro-poor budget. The pro-poor spending comprises of education, health, water and sanitation. Education and health institutions are scarce and the few that do exist are in poor shape and ill equipped (Matoc: 2010).

Moreover, if oil revenues are invested in favor of productive sectors like agriculture and livestock, it will influence total economic output of the economy in terms of income and expenditure, unemployment, inflation, etc. Southern Sudan, being a developing area, is plagued by a combination of acute unemployment and soaring prices of cattle in the rural areas and other goods and services including housing accommodation and hotels in Juba. Lack of creativity in employing projects or anti-poverty projects has created youth idleness and has encouraged cattle raids in rural areas as well as urban migration to cities (Matoc: 2010). Above all, it has induced many young people to seek political appointments in ministerial positions as a means of earning income. If this situation is not addressed now, it will lead to imbalanced growth of the economy.

GOSS need to prepare to fund projects that are now being funded by donors. By 2011, development programs include a doubling of primary school enrolment, particularly an increase of girl enrolment from 11 percent to 40 percent, an increase in the number of village schools to over 3,000, and the development of a standard curriculum (JAM,2005).

There are major concerns with respect to this development package. The GOSS will have to finance over 60 percent of southern Sudan infrastructural program in 2011. The longer GOSS delays introducing the additional sources of their own revenues provided in the CPA, it will lack adequate financial resources to meet its infrastructural spending and development aims. Also, another implication is that GOSS will be incapable of sustaining its financial integrity and will lack independent economic policies that could lift southern Sudan from underdevelopment to development.

However, GOSS fiscal policies need some improvements and this seems to be taking shape. Fortunately, the GOSS-proposed budget for 2008 estimates Sudanese pounds 3,487,864,076 billion to be raised through oil resources, personal income tax, customs duties, value added tax, corporate taxes, airport fee, nationality and immigrants fee and non-taxes (Vuni, Sudan Tribune, 2008). Financial viability and sustainability of the GOSS is dependent on the introduction of its own revenues and the use of oil revenues to develop other economic sectors to ensure reconstruction and development in the long run (Matoc: 2010).

One important improvement in this budget formulation is that GOSS allocations in the budget together with share or percentage contributions of donor grants and Multi Donor Trust Fund are indicated against each sector. This implies that there is assurance and commitment on
the side of donors to support reconstruction and development programmes of the post war southern Sudan in specific terms. To ensure development, MDTF contributions were allocated as follows: Accountability 26.8 percent, Education 6 percent, Health 15.1 percent, Infrastructure 23.3 percent, Natural Resources 19.8 percent, Public administration 2.7 percent, and Rule of Law 6.4 percent. On the other hand, the GOSS budget allocations against these important sectors were 1.3 percent, 2.8 percent, 7.3 percent, 5.4 percent, 20.1 percent, 3.8 percent, 4.2 percent, 6.4 percent, 36.2 percent and 1.2 percent respectively. However, tracing resource allocation or observing the reality on the ground results in a negative impression. For example, infrastructure, education and health, infrastructural services such as electricity, and water have been scarce for the last few years, even in towns such as Juba (Matocc: 2010). Education and health facilities are still inadequate in many rural areas of southern Sudan, which illustrates that resources have not been invested in accordance with budgetary allocations. However, the challenges discussed above are not the only ones. Others include lack of institutional capacity (budget auditing or postmortem), absorptive capacity, and other serious governance issues pertaining to the inherent political insecurity which drives GOSS to overspend on arms (Matoc: 2010).

For GOSS, both current expenditure or development expenditure have been based mostly on oil revenues for the last four years. The share of non-tax revenues is insignificant. This also implies that GOSS relies on oil revenues for both current and development expenditure. Another observation is that the flow of donor grants and Multi Donor Trust Fund started to be realized in 2006, 2007 and in 2008 in relatively significant terms (Matoc: 2010).

CONCLUSIONS AND FUTURE REFLECTIONS

This paper asks why the process of transition in Sudan did not deliver the expected benefits and seeks to explain the apparent impasse and likely failure of the envisaged transition. By addressing a complex web of factors, this paper aims to answer what went wrong since the signing of the CPA. What has characterized the implementation of power-sharing? How have the institutions of hybrid (authoritarian-democratic) governance derailed the peace process and shaped service delivery? Why has post-CPA economic reconstruction failed? Why did market-oriented policies and economic liberalization seem to have accentuated existing (spatial and social) inequalities, while failing to create a liberal economic environment?

The analysis of the issues above suggests three fundamental conclusions. First, because of the overwhelming dependency of the economy (and ruling elites) on oil, and the lack of inclusivity, the CPA has rewarded the militarized parties, marginalized the traditional polity, and appeased regional and international forces. While succeeding in putting an end to North-South conflict, the lack of representation and inclusivity, inter alia, invited a new wave of violent protest expressed in an insurgency in the north (Darfur), tribal conflicts in the south, discontent in the East, political tension in the North. This accentuated already existing centrifugal tendencies, undermined trust in public institutions and lead to violent clashes over poor service delivery in many parts in the North and over construction of dams in the far North. Compared to other post-conflict experiences, this appears to be a rather unique, and unfortunate, outcome of the Sudanese peace process.

Second, another problem with the CPA is that it sacrificed the instruments for securing the unity of the country through democratic and sustainable peace for the short-term ends of ensuring a speedy peace deal confined to the two military protagonists. The peace agreement has, therefore, been effectively reduced to an instrument for sustaining the grip of the NCP on the
country, while finding space at the center for the SPLM and creating a state in the south. However, by reinforcing the power of the state and its exploitive relationship with the peripheries, including the south, the mediation undermined its other stated objective of making unity attractive. Moreover, as it became clear that the NCP and the SPLM are drifting apart and that the envisaged referendum is likely to lead to the partitioning of the country,223 the April 2001 elections that were hoped to usher the country into a new era of democratic peace were turned by the two ruling parties into a sideshow. We have argued that the manipulation of the electoral process by the two ruling parties has happened with the acquiescence of the African and international communities, which have failed to account for the rich democratic legacy that could have been positively deployed in the design of the CPA.

Third, the struggle over oil resources in anticipation of the self-determination referendum as well as the need by the two ruling parties to maintain the allegiance of their military-security apparatus while facing serious challenges (such as Darfur for the NCP or tribal violence for the SPLM) has also significantly shaped their post-conflict economic policy and service delivery agenda. Therefore, the oil-dominated state resources were mainly allocated to the military as the state essentially withdrew from funding the social sector, a unique feature of post-conflict economic policy that is atypical for countries coming out of conflict. Moreover, the decision by donors not to extend sufficient aid to the NCP government in the North due to the alleged human rights violations in Darfur meant that there was no peace dividend for the NCP other than the oil rents.

Fourth, we offer some thoughts on three pivotal questions: How realistic is the possibility of a relapse to violent conflict between the North and South; what is the likely role of oil in preventing or causing such conflict; and what are the prospects for broader and more robust economic cooperation between the two Sudan(s)? If, in the aftermath of January 2011, the country is partitioned, the economic consequences will be far-reaching, indeed devastating for both Sudan(s). However, the NCP and the SPLM might find ways to avoid major conflict and forge some limited cooperative arrangements. This is because the very survival of the two regimes might very well depend on such a deal, which also appears to enjoy strong support from key external actors in the international community, most notably the US. At most it is likely that, failing the achievement of complete peace, the two emerging governments may resort to localized proxy conflicts in lieu of a major inter-state war. Therefore, we will argue, though oil could be a source of conflicts, it appears that at least in the short run, it could be an agent of peace between the two governments. However, even under the best case scenario of no major conflicts, no positive gains are likely from partition, at least until 2020. This is because the North is not likely to recover from the loss of oil revenue, even under a post-referendum oil deal. The adjustment in the North would require a difficult political economy with regard to the implications of a potential downsizing of budget outlays for the military-security establishment. On the other hand, effective management of the oil wealth will be a major challenge for the landlocked and human resource-scarce South. Furthermore, the prospects for broad economic cooperation would hinge on amicably resolving several thorny issues that have beset the relationship between the two parties (e.g. Abyei, the border demarcation, the nomadic tribes..etc.). This would, in turn, require strong support from external actors, not just for a limited oil deal but for a deeper longer-term economic interdependence. However, this is not likely.

223 The sudden death of John Garang constituted a major political shock to the country and the SPLM in particular. Most observers believe that the absence of John Garang has weakened the influence of the SPLM in the North as well as its commitment to the unity of the country.
without major post-referendum political openness and democratization in both Sudans. It seems that the absence of genuine democratic governance structures may not only lead to the partition of the country but could as well lead to a non-cooperative and possibly eventually a conflictive relationship between the two emerging Sudanese states. Therefore, by failing to produce “democratic peace,” the CPA is likely to cast a long dark shadow on the future of Sudan.

Finally, the value added case of Sudan to comparative research on post-conflict societies seems to suggest that rather than aligning Sudan with cases such as that of centre holding and defeating rebels (Sri Lanka), the country is edging more closely toward a “sort of” Yugoslavia paradigm (centre collapse with multiple disintegration). Alternatively, one may also consider Sudan as a “stand-alone” paradigmatic case of structural impasse in post-conflict transitions. The current political upheavals in North Africa and the Middle East may also bring an added factor further highlighting the significance and urgency of democratic transformation in the North, where a number of violent conflicts are yet to be resolved in a manner that would maintain the territorial integrity of what is left of Sudan together or else risk collapse and further disintegration.
## Table 1: Sudan- Expenditure Allocation in the 2010 Budget

<table>
<thead>
<tr>
<th>Sector/item</th>
<th>Allocation in millions of SGD</th>
<th>Percent of total (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Referendum &amp; elections</td>
<td>790</td>
<td>7.37</td>
</tr>
<tr>
<td>Sovereign Sector</td>
<td>1100</td>
<td>10.30</td>
</tr>
<tr>
<td>Security, Defense and the Policy</td>
<td>6500</td>
<td>60.60</td>
</tr>
<tr>
<td>Agricultural sector</td>
<td>918</td>
<td>8.56</td>
</tr>
<tr>
<td>Industrial sector</td>
<td>76</td>
<td>0.71</td>
</tr>
<tr>
<td>Energy &amp; mining sector</td>
<td>304</td>
<td>2.84</td>
</tr>
<tr>
<td>Health sector</td>
<td>491</td>
<td>4.58</td>
</tr>
<tr>
<td>Education sector</td>
<td>540</td>
<td>5.04</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>10719</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

**Notes:** Approved by the Council of Ministers  
Source: The Sudani Newspaper, 4 November 2009
Table 2: Governance in Sudan – 2008

<table>
<thead>
<tr>
<th>Countries</th>
<th>Voice and Accountability</th>
<th>Political Stability</th>
<th>Government Effectiveness</th>
<th>Regulatory Quality</th>
<th>Rule of Law</th>
<th>Control of Corruption</th>
<th>Overall Governance Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sudan</td>
<td>-1.77</td>
<td>-2.44</td>
<td>-1.41</td>
<td>-1.36</td>
<td>-1.5</td>
<td>-1.49</td>
<td>-1.66</td>
</tr>
<tr>
<td>Min of Developing &amp; Emerging Countries*</td>
<td>-2.2</td>
<td>-2.44</td>
<td>-1.89</td>
<td>-2.18</td>
<td>-1.81</td>
<td>-1.62</td>
<td>-2.02</td>
</tr>
<tr>
<td>Max of Developing &amp; Emerging Countries*</td>
<td>1.24</td>
<td>1.4</td>
<td>1.24</td>
<td>1.58</td>
<td>1.25</td>
<td>1.38</td>
<td>1.35</td>
</tr>
</tbody>
</table>

Notes: this index captures six key dimensions of Governance and cover 212 countries and territories. They are measured in units ranging from -2.5 to +2.5 and drawn from 35 different data sources. The 6 dimensions are:

- Voice and Accountability: the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, association, and the press.
- Political Stability: the likelihood that the government will be destabilized by unconstitutional or violent means, including terrorism.
- Government Effectiveness: the quality of public services, the capacity of the civil service and its independence from political pressures; the quality of policy formulation
- Regulatory Quality: the ability of the government to provide sound policies and regulations that enable and promote private sector development
- Rule of Law: the extent to which agents have confidence in and abide by the rules of society, including the quality of property rights, the police, and the courts, as well as the risk of crime
- Control of Corruption: the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as elite "capture" of the state
Figure 4: Sudan’s Democratic Performance vis-a-vis the Median Sub-Saharan Africa Country (1954-2004), Polity IV

Note: The index ranges from -10 (most autocratic) to 10 (most democratic).
Source: Polity IV.

Figure 5: Sudan’s Democratic Performance vis-a-vis the Median Sub-Saharan Country (1972-2005), Freedom House Political Rights

Note: The index ranges from 1 (free) to 7 (not free).
Figure 6: Estimated regional poverty rates (1999/2000)

Source: JAM (2005)

Note: Poverty rate defined as the proportion below 40% of an economic status index based on asset ownership; years 2000 (North), 1999 (South); World Bank staff calculations based on MICs and DHS surveys.
Figure 7: Net primary school % age attendance rate by state (2006)

Note: Proportion of children of primary-school age currently attending primary or secondary school.

Source: UNICEF (2007)

Figure 8: Proportion of births attended by skilled health personnel (2006)

Note: The proportions are give in percentage form.

Figure 9: Actual and "Optimum" Federal Grants: State by State (2005)

Source: Elbadawi and Suliman (2007).
Figure 10: GDP Per Capita Growth and Aid/GDP
(African countries, Median values, in percent)
Figure 11: Sudan’s Real GDP Per Capita and Real Exchange Rate Undervaluation

Notes: Real GDP Per Capita (Constant Prices: Chain Series) Source – PWT 6.3; RER Undervaluation was calculated using Rodrik’s (2008) method and PWT 6.3.
Figure 12: Genuine Savings in Mineral and Energy-Rich Countries (2006)
REFERENCES

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Exchange Rate Regimes for Post-Conflict Recovery

Ibrahim Elbadawi and Raimundo Soto

INTRODUCTION

The economic agenda for post-conflict transition has been dominated by issues of aid effectiveness. This is because countries coming out of civil wars usually have large needs, both humanitarian and developmental. Therefore, aid can play an important role in the post-conflict reconstruction of these economies as well in consolidating peace and reducing risks of future conflicts. And because of their huge potential for catch-up growth, these economies tend to have high absorptive capacities and aid can be highly effective, even with modest improvements in the institutional and policy environments. However, growth sustainability in the medium-to-longer runs, following the immediate few years of the peace onset, depends not only upon continued flows of adequate and timely aid but also on its effectiveness (e.g. Collier and Hoeffler, 2004b). Therefore, the agenda has so far almost exclusively focused on fiscal institutions and appropriate mechanisms for delivery, absorption and spending of aid. These are now standard issues in the aid effectiveness literature and have already attracted considerable academic and policy interest.224

This paper, however, argues that the received literature has been lopsided in that it has largely ignored the important issue of what constitutes an optimal exchange rate and monetary regime for post-conflict. Therefore, this paper contributes to this literature by assessing the post-conflict macroeconomic implications of three broad types of exchange rate-monetary regimes: fixed, managed and floating. In this context the paper asks whether aid effectiveness in promoting exports, overall economic growth or macro stability is conditional on the choice of exchange rate regime. The received literature suggests that, among other things, these key macroeconomic targets are critical for minimizing the risk of post-conflict relapse in the aftermath of civil wars (e.g. Elbadawi, 2008).

The literature also suggests that as institutions for contract enforcement start to break down during civil wars and social order collapses, agents disengage from transactions-related activities (e.g. transport and trade) and asset-providing activities (transport, financial services), as well as from economic activities that are intensive in assets and/or transactions, like most exports. Consequently, the major growth deceleration experienced by most conflict countries, including outright growth collapse in many, has been associated with disproportionately higher decline in their exporting capacity (Collier, 1999). Moreover, the demand for domestic money, as an asset that facilitates transactions and stores value, would also shrink during conflict (e.g. Elbadawi and Schmidt-Hebbel, 2008). Therefore, restoring growth in post-conflict requires a vigorous recovery by the export sector and an adequate re-monetization process. Unfortunately, extending the growth spells in post-conflict countries long enough to allow the reduction of post-conflict risks to relatively safe levels has been an elusive goal for most post-conflict countries. For example, in his analysis of post-conflict growth in Sub-Saharan Africa, Elbadawi (2010) finds that the median country would rebound from a negative per capita growth rate of about -1 percent in the year before peace onset to more than 2 percent in the second year; and despite the

224 See, for example, Boyce and O’Donnell (2007), Collier and Hoeffler (2004a).
high volatility across countries the average median growth hovered around 2.5 percent up to the sixth year. However, growth tends to falter and decelerates to around 0.1 percent thereafter.

Therefore, the post-conflict policy agenda has focused on the quality of institutions for managing aid, especially with regard to infrastructure and the delivery of social services. Moreover, and due to the high share of oil and other mineral exporting countries among post-conflict countries, the literature has also focused on the management of commodity booms and on institutions for ensuring the fairness and transparency of granting minerals and oil concessions (e.g. Collier, 2009). It is, of course, a no brainer to stress that this agenda are absolutely critical and should be diligently pursued. However, these policies need time to take hold. On the other hand, recent evidence from the growth literature suggests that real exchange rate (RER) undervaluation promotes growth and that countries that managed to engineer extended undervaluation episodes are also likely to achieve sustained growth transitions (see for example, Aghion et al, 2006; Aguirre and Calderon, 2006; Elbadawi et al, 2007; and Rodrik, 2008). Moreover, some contributors to this literature have characterized real exchange rate undervaluation as the centerpiece of the recent successful export-oriented development strategies of low and middle income countries. China is the most notable example but numerous other experiences can be cited as well (Rodrik, 2008).

Taking into account the above issues, this paper estimates extended empirical per capita GDP and export growth models accounting for their standard determinants as well as the impact of aid and RER undervaluation under various exchange rate regimes. In particular, this analysis allows testing for the extent to which real exchange rate undervaluation enhances aid effectiveness for promoting economic recovery and whether the aid-RER interaction effect differs across exchange rate regimes.

Beyond revitalizing exports and growth, the third pivotal macroeconomic policy objective for post-conflict is restoring macroeconomic stability through promoting the recovery in the demand for money. Adam, Collier, and Davies (2008) discuss the financing implications for the government of the decline in the demand for money associated with reduced income and asset substitution away from domestic money during conflicts. This, they argue, is likely to worsen the tradeoff between seigniorage and inflation, given that governments fighting civil wars are in need to finance higher military expenditure with limited borrowing options. Under these conditions, they formally show that the equilibrium rate of inflation that the government is willing to tolerate for a given level of seigniorage will be much higher than under normal peaceful conditions. As a result of the slow recovery in the demand for money in the aftermath of conflict and the high level of financing, inflation is not likely to decline even after war ends.

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225 Simply put, a country will experience a real currency undervaluation (overvaluation) when it produces a given basket of goods and services that can be traded across international borders at a lower (higher) cost than what would be consistent with its sustainable economic fundamentals—such as the external terms of trade; the level of sophistication of its economy or the stock of wealth generated by or endowed with the economy. Moreover, real exchange rate (real currency) undervaluation (overvaluation) is consistent with higher price of traded goods relative to non-traded domestic goods and services. When a currency is under-or-undervalued, it is necessarily misaligned relative to its long-term equilibrium level.

226 For example, Williamson (1997) argues that, to overcome the initially limited capability for exporting manufactures and other non-traditional products and to give exporters a competitive edge in the international market, the real exchange rate may have to depreciate quite considerably, overshooting its eventual equilibrium value so as to make the non-traditional export sector an appealing destination for investment. See also Elbadawi and Helleiner (2004) for similar arguments in the African context.
The key insight of Adam et al. is that without aid, conflict and post-conflict countries are likely to experience explosive inflation; aid can help reestablish the pre-conflict equilibrium level of inflation. This paper extends their analysis based on the observation that the ability of aid to finance post-conflict monetary reconstruction may depend in a substantial manner on the choice of the exchange regime. As long recognized, exchange rate regimes provide for different degrees of independence to monetary policy, protection against real shocks, and macroeconomic stabilization. Consequently, the support that aid can give to monetary reconstruction is likely to be different in fixed or managed float systems.

The paper is organized as follows. Section 2 briefly reviews the received knowledge about the factors that affect the onset of civil conflict, the impact such conflicts have on an economy and its inhabitants, and the recovery process after peace is achieved. Our aim is to identify the salient features that a framework for choosing monetary and exchange rate regimes ought to consider. Section 3 reviews the empirical evidence on the macroeconomic performance of economies with significant armed conflicts. One purpose of this section is to validate previous finding by other scholars using a database comprising 38 civil conflict countries in the 1970-2008 period and a control group of 94 countries. More importantly, this section aims at identifying additional stylized facts we deem may be important when choosing exchange and monetary regimes in post-conflict economies. Section 4 undertakes the empirical testing of the set of questions raised in the previous sections. We first replicate the main results of the empirical literature on the determinants of economic growth, inflation, money demand and export growth. Later these models are extended to consider the differential role of exchange and monetary regimes in conflict economies. Our database comprises an unbalanced panel of 132 economies and eight consecutive five-year periods covering the period 1970-2008. The econometric estimations are performed using the generalized method-of-moments (GMM) estimator for dynamic models of panel data. These estimators deal effectively with dynamic models, unobserved country-specific effects, and the potential problem of endogeneity of the explanatory variables. Finally, section 5 collects the main results which form the basis of the policy recommendations of this paper.

RECEIVED KNOWLEDGE

At the theoretical level, economic research on the causes of civil conflicts initially focused on the ‘greed vs. grievance’ issue and find that civil wars are explicable by the former, while the latter set of factors do not have a robust relationship with the risk of conflicts (Collier and Hoeffler, 2004a). However, more recently Bodea and Elbadawi (2008) argue that once political violence is correctly modeled as a complex process with multiple manifestations, one of which is civil war, both grievance (e.g. political exclusion, social polarization) and economic factors (e.g. poverty, appropriable natural resources, uneducated males, etc.) are all relevant for explaining the risk of civil war. Empirically, researchers tend to conclude that countries engaging in civil wars have lower levels of economic development and reliance on primary exports (Collier and Hoeffler, 1998), higher levels of polarization and ethnic fractionalization (Elbadawi and Sambanis, 2002), abundance of natural resources (Collier and Hoeffler, 2004a), weak central governments in financial, organizational, and political terms (Fearon and Laitin, 2003), and be located in areas prone to conflict spillovers (Murdoch and Sandler, 2002). These studies had been criticized for the absence of a causal explanation for civil conflict (Sambanis, 2004) and their lack of robustness (Hegre and Sambanis, 2006).
While there may be disagreement on the best way to model the determinants of conflicts, a broad consensus has emerged that civil conflicts are quite costly. Based on a sample of 19 civil wars in the period 1960-1989, Collier (1999) finds that on average it reduces annual real GDP growth by as much as two percentage points and that the negative impact persists long after the conflict has ended. Beyond the activity decline, Caplan (2001) finds evidence in a sample of 66 countries over the period from 1950-1992 that the negative growth effect is shaped by changes in fiscal policy, as the composition of government spending switches from social to military spending. Gupta et al. (2002) and Adam et al. (2008) provide evidence that conflicts lead to higher inflation and argue that this, most likely, is a direct consequence of the government’s need to finance increased military expenditures in a context where borrowing is unlikely to be an option. Staines (2004) finds that the damage to growth caused by poor macroeconomic policies was nearly as great as the direct impact of conflict.

External assistance had been identified as affecting conflict duration and the recovery process after peace. Early studies identified foreign aid as an important factor in sustaining conflicts in the aftermath of the Cold War era (Michailof et al., 2002). Recent studies, nevertheless, indicate that donors now generally reduce assistance sharply during conflicts but tend to increase assistance equally sharply after the conflict (Staines, 2004). This may have contributed to more severe economic contractions and imbalances experienced by countries in these later conflicts and plausibly also contributed to their shorter duration.

The costs of civil conflicts are high even after they end. However, and contrary to Collier’s (1999) earlier results, Chen et al. (2008) find that post-war economic recovery is quite rapid in cases where resolution of conflicts led to at least ten years of uninterrupted peace. For a sample of 22 countries, they observe a tremendous postwar surge in per-capita income growth, which rises about 2.5 percentage points above the prewar level. The strong recovery in income is linked to the high potential for catch-up growth following the destruction of war and is supported by an increase in both investment and capacity utilization. The length of the conflict, nevertheless, negatively affects the speed of recovery. Also, while it takes several years to re-establish the pre-conflict income levels, institutions and social indicators take much longer to improve.

The rebound in growth is also associated with a rapid decline in inflation and a realignment of fiscal policy away from military expenditure, a much needed policy since there is a tendency for countries to emerge from conflict with severely reduced domestic revenues and damaged tax administration (see Fallon et al. 2004). Chen et al. (2008) found that military expenditure (as a percentage of government expenditure) reveals a clear and significant declining trend in the aftermath of war. On the other hand, they find that inflation is significantly higher after the war. Staines (2004) notes, nevertheless, that in most of the post-1990 conflict countries inflation declined to single digits within two years.

Price stabilization tends to significantly affect monetary holdings in economies transiting from conflict to peace. Elbadawi and Schmidt-Hebbel (2008) study the stability of money demand in emerging economies—including 48 post-conflict countries—between 1975 and 2004. They conclude that M1 money demand (and therefore real monetary holdings) is highly unstable between conflict and non-conflict countries and over the conflict cycle. After peace onset, significant real monetization takes place in countries that have suffered conflicts. This

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227 For more recent evidence on the growth impact of civil war and other manifestations of political violence, see Bodea and Elbadawi (2008).
monetization results from output recovery and inflation stabilization observed immediately after conflict resolution.

External aid flows also play a significant role in affecting the aftermath of conflicts. Based on a sample of 27 post-conflict countries in the 1990s, Collier and Hoeffler (2004b) find that during the first three post-conflict years absorptive capacity for aid is no greater than normal, but that in the rest of the first decade it is approximately double its normal level. Consequently, they advocate for reversing the current situation where aid flows tend to be initially similar to pre-conflict levels and to taper out over the course of the decade. Adam et al. (2008), on the other hand, indicate that post-conflict aid stimulates the demand for money directly, by substituting for seigniorage, and indirectly, by restoring income growth and supporting a modest portfolio shift in favor of domestic money. However, the recovery in the demand for money is slow and inflation is not likely to decline rapidly if government financing remains high. Consequently, post-conflict countries are likely to experience explosive inflation unless foreign aid is available to finance fiscal imbalances and help reestablish the pre-conflict equilibrium level of inflation.

In spite of its beneficial financing role, foreign aid flows can have significant side effects on exchange markets. Civil wars disproportionately affect the traded goods sector and the extent of recovery in this sector is thus likely to have a significant effect on post-conflict growth. While aid can directly contribute to the growth of the traded-goods sector, it also raises concerns on its potential capacity to overvalue the currency. In this regard, the evolution of the real exchange rate (RER) is an important indicator of the evolution of post-conflict economies. Elbadawi et al. (2008) provide evidence that aid promotes growth but with diminishing returns and that RER overvaluation has direct negative level effects on growth and also indirectly through its interaction with aid. Simulations of the effect of a one standard deviation increase in RER overvaluation suggest that the loss in per capita growth for post-conflict countries that are highly dependent on aid and have weak financial sectors could be as high as half a percentage point per year.

In summary, the existing research provides ample evidence on the sources and impacts of armed conflicts. However, it falls short of investigating the effects that the choice of monetary and exchange rate regimes can have on post-conflict economic recovery, in particular on sustained growth and macroeconomic stability. Although there is an ample literature on the choice of the exchange regime in developing countries, researchers have largely neglected the study of post-conflict economies. However, it is for these economies that the choice of the exchange regime and monetary policy is crucial, since they start from very weak economic foundations and face the substantial institutional and political challenges imposed by post-war reconstruction. Choosing the appropriate exchange regime (floating, managed float, or fixed) and a consistent monetary policy could help achieving sustained income recovery, export expansion and low inflation. By contrast, a wrongly chosen regime can distort incentives to production via a severely misaligned real exchange rate, increase macroeconomic risk, reduce investment efforts and hamper sustained economic growth. From these considerations, the following questions are studied in this paper: (a) which exchange rate regime is more conducive to fast and high post-conflict economic growth?; (b) does export growth depend on the choice of the monetary and exchange rate regimes; (c) which exchange regime allows for easier monetization after conflicts and thus to regain normal operations of monetary policy?; and, do the different monetary and exchange rate regimes allow for different speeds in achieving macroeconomic stability (e.g., low inflation)?
STYLIZED FACTS

We review the empirical evidence on the macroeconomic performance of economies with significant armed conflicts to validate previous findings and identify additional stylized facts that we deem important when choosing exchange and monetary regimes. We collected data for 38 countries with significant armed conflicts in the period 1970-2008 and a control group of around 94 economies. Table 1 identifies the countries and time periods of civil-conflicts in our sample.

Clearly, wars initiated in the 1970s and 1980s lasted much longer than those initiated in the 1990s, a fact that is consistent with the evidence in Staines (2004). Our sample does not significantly overlap with that of Staines, since we use a more strict definition of what constitutes a significant conflict and consider a longer period of time and larger number of countries.228 The average length of conflict before 1990 is around 15 years, while afterwards they last around five years. Note also that the majority of conflicts are located in Africa (50 percent), while the rest spread evenly between Latin America, Middle East and North Africa, and Asia.

We follow Chen et al. (2008) in using an event study methodology in which calendar time is transformed into “event time” in order to aggregate a collection of experiences that share a particular event in common and extract meaningful conclusions from them. While this is useful, one should bear in mind the potential limitations of combining experiences that actually occurred at different periods of time. The econometric analysis in Section 4 overcomes this limitation.

Table 1
Countries, duration, and dates of conflicts

<table>
<thead>
<tr>
<th>Africa</th>
<th>Latin America</th>
<th>Asia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mali (1990-1995)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mauritania (1975-1978)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mozambique (1975-1992)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Senegal (1989-1997)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sierra Leone (1991-2001)</td>
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<td>South Africa (1976-1988)</td>
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<td></td>
</tr>
<tr>
<td>Sudan (1982-2002)</td>
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<td></td>
</tr>
<tr>
<td>Uganda (1978-1986)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zimbabwe (1974-1979)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mid. East &amp; N. Africa</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Algeria (1991-2008)</td>
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<td></td>
</tr>
<tr>
<td>Egypt (1994-1997)</td>
<td></td>
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<td>Iran (1978-2008)</td>
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<td></td>
</tr>
<tr>
<td>Morocco (1975-1989)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Syria (1979-1982)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Own elaboration based on data from PRIO and Elbadawi et al. (2008).

228 We use PRIO Type 1 and 2 (see UCDP/PRIO Armed Conflict Dataset v4-2009), while Staines includes also Type 3 conflicts.
Table 2 provides selected indicators of the macroeconomic performance of the countries in our sample, which we split into conflict economies and other emerging economies. Some of the stylized facts of the literature found by other authors are reproduced in our sample. We find that civil wars are very costly: the annual growth in GDP per capita during the conflict is around two percentage points below that of other developing countries. Productivity growth actually declines in war ravaged countries. When compared to non-conflict emerging countries, economies with significant civil conflicts also suffer from higher levels of inflation, substantially lower levels of foreign direct investment and more restrictive capital controls. Contrary to other papers of this literature, we do not find evidence of higher military expenditures prior, during, or after the civil conflict: all emerging economies spend around 2.7 percentage points of GDP in the military. However, this comparison does not account for the usually clandestine military aid to both sides of the civil war. As extensively documented in the literature, military aid is just one of many forms of external interventions on civil wars.229

<table>
<thead>
<tr>
<th>Table 2</th>
<th>Main Macroeconomic Indicators of Conflict and Non-Conflict Emerging Economies (1970-2008)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Non Conflict Countries</td>
</tr>
<tr>
<td>Economic Growtha</td>
<td>2.0</td>
</tr>
<tr>
<td>Labor Productivity Growthb</td>
<td>1.3</td>
</tr>
<tr>
<td>Annual Inflation Ratec</td>
<td>8.1</td>
</tr>
<tr>
<td>Dom. Credit to Private Sectord</td>
<td>31.1</td>
</tr>
<tr>
<td>Capital Account Openness Indexe</td>
<td>-0.27</td>
</tr>
<tr>
<td>Tax Revenued</td>
<td>16.4</td>
</tr>
<tr>
<td>Military Expendituresd</td>
<td>2.6</td>
</tr>
<tr>
<td>Exports Growthf</td>
<td>5.5</td>
</tr>
<tr>
<td>Exports Levelg</td>
<td>35.7</td>
</tr>
<tr>
<td>External Aidh</td>
<td>6.8</td>
</tr>
<tr>
<td>Foreign Direct Investmentd</td>
<td>3.3</td>
</tr>
</tbody>
</table>

Source: own elaboration based on IMF and World Bank data (see Appendix A).
Notes: (a) annual change in real GDP per capita (%); (b) annual change in real GDP at PPP Prices per worker (%); (c) annual rate for the median country (%); (d) annual average, as percent of GDP, (e) Chinn-Ito index, and (f) annual change in real US$.229

Countries that have suffered a civil war tend to have had poor macroeconomic performances before the onset of the conflict. This shows in several indicators in Table 2. On one hand, economic growth faltered for at least five years before the conflict, as reflected in a very slow growth in per capita GDP and in labor productivity (a proxy for labor wages and household income): as a benchmark consider that the developed economies have sustained a productivity growth rate of around 1.4 percent per year in the entire 20th century (Kehoe and Prescott, 2002). Likewise, civil wars place a big burden on the exporting capacities of conflict economies, in

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229 See, for example, Brown (1996), Regan (2000, 2002), and Walter (1999).
particular in countries affected by short-term wars, as resources are diverted away from international trade. After conflicts end, there is a vigorous and significant expansion in exports. Other macroeconomic indicators associated with higher degrees of development indicate conflict countries were lagging behind before the strife erupted, including financial development (credit to the private sector), trade openness (exports as ratio to GDP), capital account openness,\textsuperscript{230} and foreign direct investment.

The evidence in our sample indicates that countries engaging in civil conflicts see aid flows diminish somewhat—though not by as much as noted by Staines (2004)—and confirms that donors increase their transfers substantially after conflicts end. On the other hand, conflicts affect somewhat fiscal revenues, which decline by around two percent points of GDP but quickly recover pre-conflict levels after achieving the peace. Finally, countries emerge from conflicts with more open capital accounts, which is congruent with higher levels of foreign direct investment.

We also found that short duration conflicts—less than eight years—tend to be far more intense than long-term wars. Short conflicts lead to substantial drops in per-capita GDP of around three percentage points per year. On the contrary, economic growth in countries that suffer long-term conflicts is reduced by around one percent point with respect to non-conflict economies, but maintains a positive long-run trend, including achieving positive in–conflict growth. Note, however, that while GDP growth is not effected substantially in long-duration conflicts, labor productivity growth is very low for prolonged periods of time (14 years on average).

Beyond economic growth and exports expansion, conflict economies do not appear to show macroeconomic indicators significantly different before, during and after the conflict. In fact, Table 2 suggests that civil-war economies are not radically different from non-conflict countries. Nevertheless, further scrutiny shows that there are significant differences in economic performance and key macroeconomic indicators in conflict economies when looking at the exchange regime. We use Reinhart and Rogoff (2004) classification of exchange rate regimes, which we extend to 2008 based on IMF information. For empirical purposes, we group the data in three categories: fixed exchange systems (dollarization, currency boards, and participation in monetary unions), intermediate systems (from crawling pegs to managed floats) and free floats.

In Table 3, we observe that before the conflicts economic growth was much higher among countries that had intermediate exchange rate regimes as compared to countries in either fixed or floating exchange systems. After conflicts ended, nevertheless, economic growth has rebounded strongly across regimes. Labor productivity naturally follows a similar path. On the other hand, countries with fixed exchange rates before the conflict started show a higher growth rate in exports than managed float countries, perhaps as a reflection of higher investment in the presence of the lower currency risks. After conflicts, export capacities recovered in a very similar form across exchange regimes. Inflation rates before conflicts differed notably: the high inflation observed in floating exchange regimes (65 percent per year) is largely due to the presence of Latin American economies that historically have had chronic high inflation. Notably, inflation declined substantially in all countries after conflicts, independent of their exchange regime.

\textsuperscript{230} Chinn-Ito’s index of capital account openness weighs IMF data on the presence of multiple exchange rates; restrictions on current account transactions; restrictions on capital account transactions; and the requirement of the surrender of export proceeds. It is, thus, an index on \textit{de jure} restrictions ranging from -1.8 to 2.5, where a higher value indicates fewer restrictions. See Chinn and Ito (2006).
The vigorous economic recovery after civil conflicts also shows in the substantial expansion in domestic credit which, in the cases of countries with fixed and intermediate exchange rate regimes, approaches the level of non-conflict emerging economies. Floating exchange regimes lag behind. Recovery, on the other hand, also shows in expanding exports in fixed exchange rate countries and, less so, in floating exchange economies, but countries with managed-float systems do not exhibit any expansion over the pre-conflict levels. Finally, foreign direct investment increases notably from its pre-war levels in all three regimes, but countries benefit more when the exchange rate is allowed to adjust.

In addition, the evidence suggests that tax collection does not improve substantially after the conflict ends. Moreover, there are virtually no differences between countries adopting fixed or floating exchange regimes. Theoretically the choice of the optimal monetary and exchange rate regime ought to depend to some extent on the fiscal policy stance. Our evidence, nevertheless, does not support that theory.

<table>
<thead>
<tr>
<th>Table 3</th>
<th>Macroeconomic Indicators of Conflict Economies According to Exchange Systems</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Average of Five Years Before Conflict Started</td>
</tr>
<tr>
<td></td>
<td>Fixed</td>
</tr>
<tr>
<td>Economic Growtha</td>
<td>0.2</td>
</tr>
<tr>
<td>Labor Productivity Growthb</td>
<td>0.0</td>
</tr>
<tr>
<td>Annual Inflation Ratec</td>
<td>5.6</td>
</tr>
<tr>
<td>Domestic Credit to Private Sectord</td>
<td>17.4</td>
</tr>
<tr>
<td>Capital Account Openness Indexe</td>
<td>-0.39</td>
</tr>
<tr>
<td>Tax Revenued</td>
<td>11.0</td>
</tr>
<tr>
<td>Military Expendituresd</td>
<td>2.0</td>
</tr>
<tr>
<td>Exports Growthf</td>
<td>5.3</td>
</tr>
<tr>
<td>Exports Levelg</td>
<td>22.6</td>
</tr>
<tr>
<td>External Aidh</td>
<td>8.0</td>
</tr>
<tr>
<td>Foreign Direct Investmentd</td>
<td>0.5</td>
</tr>
<tr>
<td>Dollarizationg</td>
<td>0.19</td>
</tr>
</tbody>
</table>

Source: own elaboration based on IMF and World Bank data (see Appendix A).
Notes: (a) annual change in real GDP per capita (%); (b) annual change in real GDP at PPP Prices per worker (%); (c) annual rate for the median country (%); (d) annual average, as percent of GDP, (e) Chinn-Ito index, (f) annual change in real US$ and (g) deposit dollarization over total deposits ratio; n.a. indicates less than five observations.

One issue that remains unaddressed is that of currency substitution. Agents living in economies that undergo dramatic events (hyperinflation, financial collapse, or civil wars) usually defend their financial assets by holding foreign currency. As discussed by Feige (2002) the existence of a typically unknown amount of foreign currency in circulation makes the outcome of domestic monetary policy uncertain. The effective money supply may be much larger than the domestic money supply and be subject to endogenous behavioral responses reflecting currency substitution on the part of the public. Eichengreen and Hausmann (1999) note that the market for domestic government debt may be completely missing in highly dollarized countries, with adverse consequences for government financing and economic growth. On the other hand,
dollarization will tend to dampen government efforts to employ inflationary finance to impose implicit taxes on domestic monetary assets. As shown in Table 3, dollarization in fixed exchange rate regimes did not change markedly between the pre and post-conflict period. In floating exchange regimes dollarization increased substantially while in intermediate regimes it declines significantly.

An important element that should be noted is that there exists substantial “persistence” in exchange rate systems. That is, countries tend to maintain their pre-conflict exchange rate system for as long as possible and, most often than not, enter the peace period with the same system they had at the onset of the conflict. As shown in the diagonal of Table 4, of the 40 countries in our sample, 28 maintained or adopted for the transition to peace exactly the same system they had before the onset of the armed conflict (i.e., 70 percent). Countries that remained in fixed exchange rate systems largely belong to African currency unions. Most of the changes in exchange regime resulted from countries abandoning fixed or pegged regimes towards floating schemes, thus increasing degrees of exchange flexibility after conflicts. Only two economies chose to implement fixed exchange regimes after the conflict, one of those choosing to dollarize its economy to control inflation (El Salvador).

<table>
<thead>
<tr>
<th>Before conflict</th>
<th>After conflict</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed</td>
<td>Fixed Intermediate Floating Total</td>
</tr>
<tr>
<td>Fixed</td>
<td>12 2 4 18</td>
</tr>
<tr>
<td>Intermediate</td>
<td>2 14 3 19</td>
</tr>
<tr>
<td>Floating</td>
<td>0 1 2 3</td>
</tr>
<tr>
<td>Total</td>
<td>14 17 9 40</td>
</tr>
</tbody>
</table>

Source: own elaboration based on IMF and World Bank data (see Appendix A).

EMPIRICAL ANALYSIS

In this section we undertake the empirical testing of the set of questions raised in the previous sections. We proceed first to replicate the main results of the empirical literature on the determinants of economic growth, inflation, money demand and export growth. We then extend these models to consider the role of exchange and monetary regimes in conflict economies.

We estimate a series of dynamic panel-data models of per capita GDP growth rates, inflation money holdings and exports growth. Our sample is dictated by data availability, particularly that for conflict economies. It contains 132 countries representing all major world regions (see Appendix B for a complete list). The regression analysis is conducted using averages of five-year periods. Each country has a minimum of three and a maximum of eight non-overlapping five-year observations spanning the years 1970–2008. Since one observation must be reserved for instrumentaton, the first period in the regression corresponds to the years 1975–1979. Due to the presence of missing observations, the actual number of countries and observations varies from model to model; however, each table identify the number of countries used in the estimation.

Our main econometric methodology is the generalized method-of moments (GMM) estimator developed for dynamic models of panel data, which was introduced by Holtz-Eakin,
Newey, and Rosen (1988), Arellano and Bond (1991), and Arellano and Bover (1995). These estimators deal effectively with the three challenges posed by our different models. First, the regression equation is dynamic in the sense that it represents a lagged-dependent variable model. Second, the regression equation includes an unobserved country-specific effect, which cannot be accounted for by regular methods (such as the within estimator) given the dynamic nature of the model. Third, the set of explanatory variables includes some that are likely to be jointly endogenously determined with the dependent variable. Moreover, the GMM estimator is best suited for the case of panel data models with a large number of cross section units and relatively short time periods.

**Economic Growth**

To study the impact of exchange rate regimes on the economic growth of post-conflict economies, we draw from the extensive empirical literature and posit an encompassing model which seeks to link a country’s economic growth rate to economic, political, and social variables. We estimate the following variation of a growth regression:

\[
y_{it} - y_{it-1} = \alpha y_{it-1} + \beta'X_{it} + \mu_i + \lambda_t + \varepsilon_{it}
\]

where \( y_{it} \) is the log of per capita output, \( X_{it} \) is a set of variables postulated as growth determinants, \( \lambda_t \) is a period-specific effect, \( \mu_i \) represents unobserved country-specific factors, and \( \varepsilon_{it} \) is the regression residual. The subscripts \( i \) and \( t \) refer to country and time period, respectively. The expression on the left-hand side of the equation is the growth rate of per capita output in a given period. On the right-hand side, the regression model includes the level of per capita output at the start of the period (to account for transitional convergence) and a set of explanatory variables measured during the same period. The time-specific effect, \( \lambda_t \), allows us to control for international conditions that change over time and affect the growth performance of all countries in the sample. The term \( \mu_i \) accounts for unobserved country specific factors that both drive growth and are potentially correlated with the explanatory variables.

**Growth Determinants**

In the last twenty years, an extensive literature on the determinants of economic growth has developed. We focus on those economic and social variables that have received the most attention in the academic literature and in policy circles as potential determinants of economic development. Following Loayza and Soto (2002) these variables are divided into five groups: transitional convergence, cyclical reversion, structural policies and institutions, stabilization policies, and external conditions (see Appendix A for details on definitions and sources).

**Transitional convergence:** One implication of the modern models is that the growth rate depends on the initial position of the economy. The conditional convergence hypothesis maintains that, ceteris paribus, poor countries should grow faster than rich ones because of decreasing returns to scale in production. We control for the initial position of the economy by including the initial level of real per capita GDP in the set of explanatory variables.

**Cyclical reversion:** While our model focuses on long-run economic growth, in the econometric estimation we are required to work with relatively short time periods (five-year averages). At these frequencies, cyclical effects are bound to play a role. We thus include the
output gap at the start of each period as a growth determinant.\footnote{Apart from improving the regression fit, controlling for the initial output gap allows us to avoid overestimating the speed of transitional convergence, which is inferred from the coefficient on initial per capita output.} The output gap used in the regression is obtained as the difference between potential and actual GDP around the start of the period. We use the Hodrick-Prescott filter to decompose GDP and estimate annual series of potential (trend) and cyclical output for each country in the sample.\footnote{Other filters proposed in this literature—such as Baxter-King or Christiano-Fitzgerald—have the drawback of losing observation at the beginning and end of the sample, thus reducing much needed degrees of freedom. See Christiano and Fitzgerald, 1999.}

Structural policies and institutions: Evidence collected in previous research indicates that economic growth can be affected by public policies and institutions. We consider explanatory variables representing all major categories of public policies. The first area of structural policies is education and human capital formation in general. Human capital can counteract the forces of diminishing returns in other factors of production—such as physical capital—to deliver long-run growth. Apart from its direct role as a factor of production, education and human capital determine the adoption rate of technological innovations. We measure the policies directed toward increasing education and human capital with the rate of educational attainment obtained from Barro and Lee’s database (Barro and Lee, 2010). The second policy area is related to financial depth. Well-functioning financial systems promote long-run growth as they facilitate risk diversification, help identify profitable investment projects and mobilize savings to them. Our measure of financial depth is the ratio of the deposit bank assets to those of the central bank. The third area is international trade openness. There are several channels through which trade affects economic growth: (a) inducing higher total factor productivity as a result of specialization and the exploitation of comparative advantages, (b) producing market expansion and use of scale economies, (c) helping diffusing technological innovations and improved managerial practices, (d) lessening anticompetitive practices of domestic firms, and (e) reducing incentives for firms to conduct rent-seeking activities that are mostly unproductive. Our measure of openness is the volume of trade (real exports plus imports) over GDP, adjusted for the size (area and population) of the country, for whether it is landlocked, and for whether it is an oil exporter. The fourth area is related to the government burden. Although a government can play a beneficial role for the economy, it can be a heavy burden if it imposes high taxes, uses this revenue to maintain ineffective public programs and a bloated bureaucracy, distorts markets incentives, and interferes negatively in the economy by assuming roles most appropriate for the private sector. We account for the burden of government through the ratio of government consumption to GDP. The fifth important area of policy involves the availability of public services and infrastructure. Whether they are treated as classic public goods or as subject to congestion, public services and infrastructure can affect growth by entering directly as inputs of the production function, by serving to improve total factor productivity, and by encouraging private investment as they help protect property rights. There are a few alternative measures of public services and infrastructure. Among these, the variable with the largest cross-country and time series coverage is telecommunications capacity, measured by the number of telephone lines per capita. The last area is related to the institutional quality of government, including the respect for civil and political rights, bureaucratic efficiency, absence of corruption, enforcement of contractual agreements, and prevalence of law and order. We use the first principal component of four indicators reported by Political Risk Services in their publication \textit{International Country Risk Guide} (ICRG). These indicators relate to the
prevalence of law and order, quality of the bureaucracy, absence of corruption, voice, political stability and accountability of public officials.

**Stabilization policies:** We include stabilization policies as determinants of economic growth for two reasons. From an econometric viewpoint it improves the regression’s fit and forecasting power increases over horizons that are relevant to economic policy (say, five to ten years). From an economic perspective, stabilization policies affect not only cyclical fluctuations, but also long-run growth. Fiscal, monetary, and financial policies that contribute to a stable macroeconomic environment and avoid financial and balance-of-payments crises are important for long run growth. By reducing uncertainty, they encourage firm investment, reduce societal disputes for the distribution of ex post rents, and allow economic agents to concentrate on productive activities (rather than trying to manage high risk). The first area in this category is related to the **lack of price stability**, which we measure by the average inflation rate. The second area is related to **external imbalances and the risk of balance-of-payments crises**. This factor is measured by an index of real exchange rate undervaluation, which reflects a strategy of providing an economy-wide subsidy to exports and tradable activities in general, given their importance for post-conflict recovery. However, to the extent that such a strategy is based upon a misaligned currency, it will eventually have to give way to a neutral equilibrium real exchange rate policy. On the other hand, the other face of the real exchange rate misalignment, namely, RER overvaluation captures the distortions in the allocation of resources between the exporting and domestic sectors. This misallocation usually leads to large external imbalances, whose correction is frequently accompanied by balance-of-payments crises and followed by sharp recessions. The third area concerns the occurrence of **systemic banking crises** and serves to account for the deleterious effect of financial turmoil on economic activity, particularly over short and medium horizons. The occurrence of banking crises is measured by the fraction of years that a country undergoes a systemic banking crisis in the corresponding period.

**External conditions:** Economic growth is shaped not only by internal factors, but also by external conditions that influence the domestic economy in both the short and long runs. We include two additional variables in the growth regression: the **terms-of-trade shocks** affecting each country individually and a **period-specific shift** affecting all countries in the sample. Terms-of-trade shocks capture changes in both the international demand for a country’s exports and the cost of production and consumption inputs. The period-specific shifts (or time dummy variables) summarize the prevalent global conditions at a given period of time and reflect worldwide recessions and booms. Moreover, we also include the level of **external aid** as share of GDP following recent papers that have found evidence that donor’s support can play a significant role in affecting economic growth in developing economies, especially those coming out of civil wars (e.g. Collier and Hoeffler, 2004b).

**Estimation Results**

Table 5 presents the results obtained by estimating the empirical model using around 537 observations for 90 countries. The specification tests (serial-correlation tests) support the GMM system estimator of our model. Column (1) in the table corresponds to the base specification; column (2) displays the results for a model that includes interaction terms designed to capture non-linear effects stemming from the presence of significant aid flows under real exchange rate misalignment, measured as undervaluation, which is presumed to enhance the effectiveness of aid, while RER overvaluation (the negative of undervaluation) should reduce aid effectiveness;
and column (3) extends the latter model to include in a candid way a dummy for each exchange rate regime (fixed, floating, and intermediate).

**Transitional convergence.** The coefficient on the initial level of per capita GDP is negative and statistically significant. It is consistent with conditional convergence—that is, holding constant other growth determinants, poorer countries grow faster than richer ones. Given the estimated coefficients, the implied speed of convergence is roughly 4 percent per year, with a corresponding half-life of about sixteen years (this is the time it takes for half the income difference between two growing countries to disappear solely due to convergence). Our estimates are higher than those in the literature (e.g., Loayza and Soto, 2002). The estimated coefficient on the initial output gap is also negative and significant. This indicates that the economies in the sample follow a trend-reverting process. In other words, if an economy is undergoing a recession at the start of the period, it is expected that its growth rate be higher than otherwise in the following years, so as to close the output gap.

**Structural policies and institutions.** All variables related to structural policies present coefficients with expected signs and statistical significance. Economic growth increases with improvements in education, financial depth, trade openness, and infrastructure. It decreases when governments apply an excessive burden on the private sector. These results are broadly consistent with a vast empirical literature on endogenous growth, including Barro and Lee (2010) on the role of education and government burden; Dollar (1992) on trade openness; Canning et al. (1994) on public infrastructure; and Levine et al. (2000) on financial depth.

**Stabilization policies.** All estimated coefficients for these variables carry the expected signs and statistical significance. Economic growth generally decreases when governments do not carry out policies conducive to macroeconomic stability, including the absence of financial and external crises. Like Fischer (1993), we find that an increase in the inflation rate leads to a reduction in economic growth. Finally, the frequency of systemic banking crises has a particularly negative effect on economic growth.

**External conditions.** Negative terms-of-trade shocks have the effect of slowing down the economy’s growth rate. As noted by Easterly et al. (1993), for instance, good luck (in the form of favorable terms-of-trade shocks) is as important as good policies in explaining growth performance over medium-term horizons (such as decades). Foreign aid, as suggested by Collier and Hoeffler (2004b), play a significant role in supporting economic growth but we also find evidence that such effect exhibits decreasing returns, as indicated by the estimated coefficient for the squared term.

We extend the basic regression to include an interaction term to test the notion that RER undervaluation not only has direct positive effects on growth but also indirectly through its interaction with aid. Plausibly, if undervaluation can be achieved even when aid is following, possibly through allocation of the latter to productivity-enhancing investment, such as much needed infrastructure, RER undervaluation can increase aid effectiveness in promoting economic growth. While we find aid to have the usual non-monotonic effect, we fail to find a significant level effect for the real exchange rate. However, as found in Elbadawi et al. (2008), we obtain that aid has a much more effective growth-enhancing effect in a macroeconomic environment of exchange rate undervaluation (see column 2). We also extend the model to study interactions between the exchange undervaluation and the degree of development of the financial sector, but find no statistically significant effect. We, therefore, could not corroborate earlier evidence in the literature, which suggests that financial development can ameliorate the negative

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233 See, for example, Sachs (2007).
effects of RER overvaluation on growth; or renders the growth promoting effect of RER undervaluation ineffective (e.g. Aghion et al, 2009; Elbadawi et al, 2007)\(^{234}\).

Table 5
Econometric Results: Growth in per capita real GDP

<table>
<thead>
<tr>
<th>Variable</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Standard Controls</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Initial GDP per capita (in logs)</td>
<td>-3.81 (0.50)***</td>
<td>-3.58 (0.48)***</td>
<td>-3.23 (0.49)***</td>
</tr>
<tr>
<td>Cyclical reversion (Initial output gap)</td>
<td>-0.21 (0.04)***</td>
<td>-0.22 (0.04)***</td>
<td>-0.22 (0.04)***</td>
</tr>
<tr>
<td>Education (secondary attainment, in logs)</td>
<td>1.61 (0.62)***</td>
<td>3.05 (0.72)***</td>
<td>2.64 (0.75)***</td>
</tr>
<tr>
<td>Trade Openness (% of GDP, in logs)</td>
<td>2.51 (0.63)***</td>
<td>2.77 (0.68)***</td>
<td>2.44 (0.67)***</td>
</tr>
<tr>
<td>Government Burden (gov. consumption % of GDP, in logs)</td>
<td>-2.62 (0.63)***</td>
<td>-2.31 (0.73)***</td>
<td>-2.32 (0.73)***</td>
</tr>
<tr>
<td>Government quality index (higher index=higher quality)</td>
<td>3.27 (1.35)**</td>
<td>2.65 (1.44)**</td>
<td>2.54 (1.40)*</td>
</tr>
<tr>
<td>Inflation (log (1+inflation rate))</td>
<td>-0.66 (0.18)***</td>
<td>-0.65 (0.20)***</td>
<td>-0.58 (0.21)***</td>
</tr>
<tr>
<td>Systemic Banking Crisis (dummy)</td>
<td>-5.55 (1.26)***</td>
<td>-5.94 (1.39)***</td>
<td>-5.88 (1.39)***</td>
</tr>
<tr>
<td>Terms of Trade Shocks (dev. from HP trend)</td>
<td>0.05 (0.03)**</td>
<td>0.04 (0.03)</td>
<td>0.03 (0.03)</td>
</tr>
<tr>
<td>Infrastructure (telephones per capita, in logs)</td>
<td>0.74 (0.25)***</td>
<td>0.76 (0.25)***</td>
<td>0.93 (0.26)***</td>
</tr>
<tr>
<td><strong>Additional Controls</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RER undervaluation (dev. from HP trend)</td>
<td>0.03 (0.03)</td>
<td>0.06 (0.04)</td>
<td>0.03 (0.04)</td>
</tr>
<tr>
<td>Aid (as % of GNI)</td>
<td>0.14 (0.06)**</td>
<td>0.24 (0.07)***</td>
<td>0.25 (0.07)***</td>
</tr>
<tr>
<td>Squared Aid (as % of GNI)</td>
<td>-0.002 (0.001)*</td>
<td>-0.003</td>
<td>0.003(0.001)**</td>
</tr>
<tr>
<td>Interaction 1: Aid*RER undervaluation</td>
<td>0.79 (0.27)***</td>
<td>0.73 (0.27)**</td>
<td></td>
</tr>
<tr>
<td>Interaction 2: Fin. Development *RER undervaluation</td>
<td>2.44 (1.58)</td>
<td>1.92 (1.60)</td>
<td></td>
</tr>
<tr>
<td><strong>Exchange Rate Regime</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed Exchange Rate</td>
<td></td>
<td></td>
<td>-0.68 (1.53)</td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td></td>
<td></td>
<td>-0.92 (1.50)</td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td></td>
<td></td>
<td>-2.05 (1.49)</td>
</tr>
<tr>
<td>Constant</td>
<td>30.3 (3.55)***</td>
<td>25.4 (3.40)***</td>
<td>23.8 (3.66)***</td>
</tr>
<tr>
<td>Serial correlation test of order 1</td>
<td>-3.34 ***</td>
<td>-3.56 ***</td>
<td>-3.24 ***</td>
</tr>
<tr>
<td>Serial correlation test of order 2</td>
<td>-1.13</td>
<td>-0.97</td>
<td>-0.93</td>
</tr>
</tbody>
</table>

Note: Number of countries=90, number of observations=537, maximum number of instruments=49, time dummies and country dummies included. (*,**,***)= significant at 90%, 95% and 99% confidence, respectively.

We extend once more the basic regression to include one dummy for each exchange rate regime taking value 1 if the country has a fixed, managed float or floating exchange rate system and zero otherwise. We denote these variables by \(D_j\) (j=1, 2, 3). We report the results in column (3) of Table 5. Two main conclusions emerge from this naïve econometric exercise. First, none of the estimated parameters are statistically different from zero, which indicates that per-se exchange rate regimes do not affect growth in a systematic way. This is not surprising as economic theory and policy practice would indicate there is nothing special in the choice of exchange regimes with respect to economic growth, but in the manner economic policy is managed conditional on such choice. Second, the estimated parameters of the other explanatory

\(^{234}\) However, it is important to note that, unlike our simple RER undervaluation measure, the RER misalignment index used in Elbadawi, for example, was based on a fully specified behavioral RER model.
variables do not change in any significant manner, statistically or economically, with the only exception of the variables linked to RER undervaluation, for which the corresponding coefficients were significantly reduced. This, on one hand, suggests that our econometric evidence regarding the standard growth controls is robust and, on the other hand, that the effects of RER undervaluation are linked to, and depend upon, the nature of the exchange regime.

In order to study the indirect impacts of the exchange regime on economic growth, we expand our econometric model. We posit that exchange regimes can induce different levels of misalignment in the RER, thereby affecting directly the performance of an economy, and indirectly via the effects of foreign aid and financial development. The dummy variables described above are crossed with the regressors to generate interaction terms of the form $D_jX_{it}$. Consequently, there will be three additional variables for each interaction term in our basic regression, one for each exchange regime we study. The complete model is thus:

\[
(2) \quad y_{it} - y_{it-1} = \alpha y_{it-1} + \beta' X_{it} + \gamma D_i + \theta_j D_j RERundervaluation_{it} + \varphi_j D_j AID_{it} + \mu_i + \lambda_t + \epsilon_{it}
\]

When reporting the results in the Table 6 we omit those for the standard controls in order to save space and focus on the purpose of this study. The results in column (1) indicate that all the interactions between RER undervaluation and the different exchange regimes are not statistically significant. This in turn suggests that there are no differences across exchange regimes in the positive effects of RER undervaluation on economic growth. Consequently, we focus hereafter only in indirect effects of currency undervaluation.

Column (2) decomposes the effects of the interaction between external aid and undervaluation on economic growth by exchange regime and post-conflict periods. It can be seen that the basic message replicates: aid positively affects long-run growth in all economies, but compared to the fixed regime, undervaluation is less effective in enhancing aid effectiveness on growth under the floating and managed floating regimes, as indicated by the significant estimated negative interaction effects (-2.26 and -1.05, respectively). Moreover, we found that in countries with floating exchange regimes undervaluation actually reduces growth when financial markets are sufficiently developed. This could be explained by the fact such countries tend to have larger non-tradable than tradable sectors. Therefore, undervaluation produces higher percentage contraction on the aggregate GDP than can be compensated for by the tradable sector.
Table 6
Econometric Results: Growth in per capita real GDP
(standard controls not reported)

<table>
<thead>
<tr>
<th>Variable</th>
<th>(1)</th>
<th>(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>RER undervaluation (deviations from HP trend)</td>
<td>-0.026 (0.161)</td>
<td>-0.029 (0.046)</td>
</tr>
<tr>
<td>Aid (as % of GNI)</td>
<td>0.257 (0.071)**</td>
<td>0.116 (0.074)*</td>
</tr>
<tr>
<td>Aid^2 (as % of GNI)</td>
<td>-0.003 (-0.001)**</td>
<td>-0.001 (0.001)</td>
</tr>
<tr>
<td>Interaction 1: Aid*RER undervaluation</td>
<td>0.774 (0.274)***</td>
<td>1.623 (0.370)***</td>
</tr>
<tr>
<td>Interaction 2: Financial Development *RER undervaluation</td>
<td>0.699 (1.800)</td>
<td>2.852 (2.566)</td>
</tr>
<tr>
<td>Interaction 3: RER undervaluation*Exchange Regime</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed Exchange Rate</td>
<td>-0.031 (0.172)</td>
<td></td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>-0.044 (0.163)</td>
<td></td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td>-0.089 (0.161)</td>
<td></td>
</tr>
<tr>
<td>Interaction 4: Aid<em>RER undervaluation</em>Exchange Regime</td>
<td>0.951 (1.221)</td>
<td></td>
</tr>
<tr>
<td>Fixed Exchange Rate</td>
<td>-2.267 (0.769)**</td>
<td></td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>-1.054 (0.677)*</td>
<td></td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interaction 5: Financial Develop.<em>RER undervaluation</em></td>
<td>0.928 (4.846)</td>
<td></td>
</tr>
<tr>
<td>Fixed Exchange Rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>2.223 (3.067)</td>
<td></td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td>-6.541 (3.025)**</td>
<td></td>
</tr>
<tr>
<td>Post Conflict Periods</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interaction 6: Aid<em>RER undervaluation</em> Post Conflict</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed Exchange Rate</td>
<td>5.693 (2.457)**</td>
<td></td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>3.073 (0.899)**</td>
<td></td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td>-4.629 (1.326)***</td>
<td></td>
</tr>
<tr>
<td>Interaction 7: Fin. Develop.<em>RER undervaluation</em> Post Conflict</td>
<td>-28.855 (25.229)</td>
<td></td>
</tr>
<tr>
<td>Fixed Exchange Rate</td>
<td>-10.395 (11.826)</td>
<td></td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>-515.12 (132.17)***</td>
<td></td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>22.60 (3.37)***</td>
<td>24.92 (3.46)***</td>
</tr>
<tr>
<td>Serial correlation test of order 1</td>
<td>-3.50 ***</td>
<td>-3.86 ***</td>
</tr>
<tr>
<td>Serial correlation test of order 2</td>
<td>-1.04</td>
<td>-1.65</td>
</tr>
</tbody>
</table>

Note: Number of countries = 90, number of observations = 537, maximum number of instruments = 63, time dummies and country dummies included. (*,**,***)= significant at 90%, 95% and 99% confidence, respectively.

When studying these interactions in post-conflict economies, noteworthy results appear: economic growth in countries with floating exchange regimes suffer considerably from the combined effects of significant aid flows and real exchange rates undervaluation. On the contrary, in countries with fixed and managed float regimes economic recovery after conflicts is enhanced by a currency undervaluation strategy, as indicated by the sizable positive coefficient which removes altogether the negative cross-country effect. Likewise, the growth impact of undervaluation in post-conflict economies with fixed and managed float is not affected by the level of financial development, while under the floating regime undervaluation further reduces growth in post-conflict countries with advanced financial markets. In a nutshell, the results of Table 6 suggest that aid recipient post-conflict countries with fixed or managed float regimes should consider a strategy of real exchange rate undervaluation for enhancing post-conflict aid effectives and accelerating growth. However, those adopting a floating regime should pursue an equilibrium real exchange rate policy or even a mild overvaluation to the extent that they have a
sizable non-tradable sector. We are hastened, however, to emphasize that there are very few such examples; only nine out of 40 post-conflict countries adopting a floating regime (Table 4).

Exports

The empirical literature on export-demand functions and economic development is vast and far reaching. At its basis lies the notion that fast, sustainable growth largely depends on the fate of the exporting sectors. The spectacular development of the Asian Tigers (Hong Kong, Singapore, Korea, Taiwan) and other newly industrialized countries, has been clearly the result of a deliberate policy effort to support and expand tradable sectors as the starting point to acquire higher productivity technologies and managerial capabilities, market access, foreign direct investment and improve the quality of the human capital of their labor force. One area that has captured the interest of researchers is the dependence of exports (and imports) on relative prices, in particular the real exchange rate: the higher the income elasticity of the export demand, the more powerful exports will be as an engine of growth. The higher the price elasticity, the more competitive is the international market for exports of the particular country, and thus the more successful will a real devaluation be in promoting export revenues. The recent literature is divided on how a real devaluation affects imports and exports. Rose (1991) and Ostry and Rose (1992) find that a real devaluation has generally no significant impact on the trade balance, while Marquez and McNeilly (1988) and Reinhart (1995) find that it does affect the trade balance.

Export Determinants

Based on the papers by Santos-Paulino and Thirlwall (2004) and Ostry and Rose (1992) we posit the following dynamic model for the growth of exports (expressed in real US$):

\[
\Delta \log \text{Exports}_{it} = \alpha \Delta \log \text{Exports}_{it-1} + \beta' X_{it} + \mu_i + \lambda_t + \epsilon_{it}
\]

where vector \( X_{it} \) includes the standard determinants of a demand function (i.e., relative prices and income levels) as well as other complimentary determinants that account for the cross section-time series data we use in the estimation.

Among these complimentary variables, we include those which relate to institutional aspects that largely determine the efficiency of exports and their competitiveness in global markets. In the empirical work we control for financial development and infrastructure. On the other hand, since we work with 5-year averages, cyclical phenomena are bound to play a role in affecting export performance: we thus control for the fluctuations of the world economy, shocks to terms of trade and the domestic cycle. The latter is justified on the grounds that the short-term growth in exports is limited to some extent by the availability of factors (capital and labor) used to manufacture exported goods: countries with substantial output-gaps would find it easier to export than those with over-heated economies.

Recent research suggests that taxes affect profitability and export growth. We include as a measure of export taxes the openness variable already used in the long-run growth section, namely the volume of trade over GDP adjusted for the area and population of each country and dummies for being landlocked and/or an oil exporter. We also consider as a potential determinant the government burden on the grounds that although governments can promote exports, it can also become a heavy burden if it imposes high taxes, distorts markets incentives,
and maintain an inefficient bureaucracy. Lastly, we add inflation to our set of regressors as it represents both an indirect tax and indicator of economic instability.

Finally, in order to continue the analysis of the previous section we include in our model foreign aid and its interactions with the undervaluation of the real exchange rate and the development of the financial sector. As discussed in the growth section, the macroeconomic impacts of aid on the exports of an emerging economy are multiple. On the positive side aid might help support investment, reduce taxation by balancing government budgets, and avoid balance of payments risks. On the negative side, aid can overvalue the currency thus hampering export profitability.

Estimation Results

Table 7 presents the results of the estimation procedure which, as in previous cases, is based on the system GMM estimator and considers 106 countries and over 500 observations. Since we include time-specific dummies, we have effectively controlled for the world economic cycle and their impact on each country’s export performance. The results in column (1) indicate that exports sectors in richer economies tend to be less dynamic, a result that is consistent with fact that higher income economies rely more on domestic goods sectors and services. Smaller economies, on the contrary, depend more on foreign trade. Likewise, economies that are on the troughs of their own cycles would tend to see exports rebound quite rapidly, as indicated by the negative estimated parameter of the cyclical reversion variable. Concordantly, economies at their peak of their cycle would reduce export growth as a result of excess domestic expenditure relative to their long-run equilibrium.

The estimation of the parameters of the rest of the variables exhibit the expected correlation to exports growth: more open economies would see exports become more competitive, lower inflation and government consumption would promote higher export growth as well as better infrastructure. Our financial development proxy has the expected positive sign but, somewhat surprisingly, is statistically insignificant.

Aid by itself seems to support exports, as indicated by the positive estimated parameter, although, as for the growth results, aid is much more effective when the real exchange rate is undervalued, which increases the profitability of the tradable export sector, as indicated by the strong positive estimate of the interaction term 1 of regression 1. The undervaluation of the currency—compounded by external financing—can jumpstart the disproportionately negatively impacted export sector during conflict by providing an economy-wide subsidy to the sector. Interaction 2, which measures the eventual amelioration of the currency undervaluation effect by the level of development of the financial sector, is insignificant thus prompting us to discard this transmission channel. Finally, exchange regimes seem to affect directly export performance: countries with floating exchange regimes exhibit lower export growth than countries with less flexible currencies. This could result from the fact that exporters in countries with floating currencies face currency risks that they cannot diversify away through the financial sector.
Table 7
Econometric Results: Annual Exports Growth (%)

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Standard Controls</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Initial Real GDP per capita (in logs)</td>
<td>-0.041 (0.012)***</td>
<td>-0.037 (0.012)***</td>
<td>-0.037 (0.012)***</td>
</tr>
<tr>
<td>Cyclical reversion (Initial output gap)</td>
<td>-0.002 (0.001)*</td>
<td>-0.003 (0.001)*</td>
<td>-0.003 (0.001)*</td>
</tr>
<tr>
<td>Trade Openness (% of GDP, in logs)</td>
<td>0.126 (0.02)***</td>
<td>0.130</td>
<td>0.125</td>
</tr>
<tr>
<td>Government Burden (gov. consumption % of GDP, in logs)</td>
<td>-0.104 (0.02)***</td>
<td>-0.091</td>
<td>-0.094 (0.020)***</td>
</tr>
<tr>
<td>Inflation (log (1+inflation rate))</td>
<td>-0.010 (0.006)*</td>
<td>-0.010 (0.006)</td>
<td>-0.004 (0.006)</td>
</tr>
<tr>
<td>Infrastructure (telephones per capita, in logs)</td>
<td>0.027 (0.007)***</td>
<td>0.022</td>
<td>0.025</td>
</tr>
<tr>
<td>Financial Development</td>
<td>0.005 (0.004)</td>
<td>0.004 (0.004)</td>
<td>0.006 (0.004)</td>
</tr>
</tbody>
</table>

| **Additional Controls** |              |              |              |
| RER undervaluation | 0.001 (0.001)  | 0.152 (0.132) | 0.185 (0.110)* |
| Aid (% of GNI, in logs) | 0.029 (0.001)*** | 0.003 (0.001)** | 0.003 (0.001)** |
| Interaction 1: Aid*RER undervaluation | 0.037 (0.009)*** |              |              |
| Interaction 2: Financial Develop. *RER undervaluation | 0.038 (0.050) |              |              |
| Exchange Regime |              |              |              |
| Fixed Exchange Rate | -0.041 (0.052) | -0.049 (0.052) | -0.023 (0.053) |
| Managed Float Exchange Rate | -0.061 (0.049) | -0.063 (0.051) | -0.042 (0.051) |
| Floating Exchange Rate | -0.119 (0.048)*** | -0.117 (0.049)*** | -0.104 (0.050)*** |
| Interaction 1: Aid*RER undervaluation*Exchange Regime |              | -0.018 (0.011)* | -0.007 (0.011)* |
| Fixed Exchange Rate | -0.025 | -0.035 |
| Managed Float Exchange Rate | (0.012)** | (0.012)** |
| Floating Exchange Rate | 0.021 (0.011)* | 0.117 (0.049)* |
| Interaction 2: Aid*Fin. development*Exchange rate regime |              | 0.023 (0.104) | - |
| Fixed Rate | 0.007 (0.049) | - |
| Managed Float Exchange Rate | 0.022 (0.077) | - |
| Interaction 3: Post Conflict*Aid*RER Under*Exc. Regime |              |              |              |
| Fixed Exchange Rate |              | -0.025 (0.106) |              |
| Managed Float Exchange Rate | 0.086 (0.045)* |              |              |
| Floating Exchange Rate | 0.138 (0.064)** |              |              |
| Constant | 0.592 (0.097)*** | 0.532 | (0.101)*** |
| Serial correlation test of order 1 | -4.96*** | -4.97*** | -4.54*** |
| Serial correlation test of order 2 | 1.32 | -1.51 | -1.38 |

Note: Number of countries=106, number of observations=520, maximum number of instruments=52, time dummies and country dummies included. (*,**,***)= significant at 90%, 95% and 99% confidence, respectively.

It is precisely the latter observation which prompted us to extend our model to include interactions terms aiming to capture differential effects of RER undervaluation and financial development in countries with different exchange regimes. The results are presented in column...
(2) of Table 7. It can be seen that the results for the standard control variables remain unaffected and, thus, we can concentrate on the interaction terms. We find that RER undervaluation compounded by aid has a positive effect under the floating regime, while it tends to reduce export growth under the other two less flexible regimes. On the other hand, the aid-financial development interaction was insignificant under all three exchange rate regimes. These results prompt us to drop the interaction terms involving financial development, but undertake further investigation to assess the impact of the post-conflict aid-undervaluation effect across the three regimes (column 3). We find that during post-conflict RER undervaluation promotes aid effectiveness under floating and managed floating regimes, while it reduces aid effectiveness under fixed regimes. The net effect of the RER undervaluation compounded with aid during post-conflict was negative for the fixed regime (at -0.03); while it remains positive for the more flexible regimes: 0.051 for the managed float, and 0.255 for the floating regime. RER undervaluation requires strong fundamentals under floating regimes, but, as our results suggest, if it can be achieved it will have a large impact on aid effectiveness in promoting export growth.

Money Holdings

As discussed before, civil war reduces GDP growth by around 2 percent over a period of seven years. Hence, the demand for money is likely to be reduced for a prolonged period both directly, as a result of the fall in income, and indirectly, as a result of the attempts of agents to protect assets from the ravages of war through capital flight. The decline in the demand for money reduces seigniorage and exacerbates the difficulties of governments to finance expenditures, which are typically heightened by military spending. As noted by Adam et al. (2008), seigniorage is strategic, both because as revenue of last resort it reveals government preferences and because the ability to raise it reflects the degree of confidence of private actors in a fundamental government commitment. While the restoration of the demand for money is beyond the capacity of the typical post-conflict government, it is both an important objective in itself and a useful indicator of the broader restoration of confidence.

We use a very simple demand for real money based on the following specification:

\[
\log M_{it} = \alpha' \log SV_{it} + \beta' AC_{it} + \gamma_i AID_{it} + \mu_i + \lambda_t + \varepsilon_{it}
\]

where \(M\) is money (as % of GDP), \(SV\) are scale variables (e.g., the log of real GDP), \(AC\) are variables representing the alternative cost of holding money, \(AID\) is foreign aid flow (as % of GDP) and parameters \(\mu, \lambda, \text{ and } \varepsilon\) represent country-fixed effects, time-fixed effects and innovations, respectively.

Money Determinants

The choice of money is not innocuous. Narrow money definitions (such as M1) tend to produce highly unstable econometric estimations in particular in dollarized economies, as reported in several studies (see Elbadawi and Schmidt-Hebbel, 2008; Oomes and Ohnsorge, 2005; Feige, 2002). Broad money demand estimations—including foreign cash holdings—tend to be more stable but also tend to become less representative of domestic monetary policies. Regarding the selection of the appropriate scale variable, standard portfolio theory of asset demands suggests using financial wealth while transaction theories of money would indicate the use of flow...
variables such as real GDP or real private consumption. Data availability forces us to use real GDP as the main scale variable, which we complement with population to allow for the possibility that the per-capita income elasticity of the demand for money deviates from 1.

The alternative cost of holding money would include both the CPI-based inflation tax and the pure alternative cost in terms of foregone interest. Domowitz and Elbadawi (1987) and Easterly et al. (1995) claim that in countries where financial assets are not good substitutes for cash balances or which experience high inflation, the rate of inflation is a dominant measure of the opportunity cost of holding money. Foregone interest, on the other hand, presents practical complications as the data on interest rates is scarce and usually contaminated with government controls, in particular in the 1970s and 1980s. We focus only in a measure of inflation tax, namely \( \pi_t/(1 + \pi_t) \), which is theoretically consistent for discrete-time variables and therefore the most appropriate measure of the inflation cost of holding money (see Calvo and Leiderman 1992).

**Estimation Results**

For our econometric estimation we use data for both M1 and M2 as percent of GDP for around 120 countries (650 observations). In Table 8, it can be seen that the estimated model for M1 in column (1) is an unlikely description of the data as the parameters are insignificant or have the wrong signs. The instability of this specification do not reduce if interaction terms for the impact of aid flows and non-linear effects are included in the estimation, as shown in column (2). On the contrary, the results in column (3) indicate that the model for broad money provides an economically sound description of monetization: the estimated coefficients for the scale variables (real GDP and population size) and aid flows are statistically significant and economically meaningful. The cost variable displays a negative sign as expected and is in line with other studies (Elbadawi and Schmidt-Hebbel, 2008). When conflict as well as post-conflict interaction terms are included in the estimation, our results indicate that the only non-linear effects arise from the aid channel, where aid flows allow the conflict and post conflict economy to maintain higher levels of monetization. On the contrary, there is no evidence of non-linear impacts from economic activity and/or inflation.

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235 Currency substitution could account for the instability of narrow-money demand functions as it could well be reflecting the fact that agents hold both domestic and external currency and can easily switch from one to the other. Consequently, monetary aggregates—such as base M1—would exhibit instability and unpredictability complicating monetary policy. On the other hand, currency substitution could explain the fact that monetization is equally strong under flexible and floating exchange rates after conflicts end. The data for dollarization is scarce and plagued with methodological shortcomings, in particular in conflict economies, which precludes us from undertaking an econometric test.
We now investigate the possible differences in monetization across exchange regimes and present the results in Table 9. Again, the model for M1 is not successful in providing an adequate description of the data: the estimated coefficients for aid and economic activity (real GDP) are not significantly different from zero, and that for population has an unexpected negative sign. The model for M2 is more consistent with the underlying data generating mechanisms: the estimated parameters are highly significant both statistically and economically and by being similar to those in table 8 they indicate that the estimation is robust. The results indicate that countries with polar exchange regimes do not see monetization decline during the civil conflicts, contrary to the conclusions by several authors. It is the countries with managed float regimes that suffer from de-monetization during civil wars as a result of the decline in external aid. However, the estimated conflict-growth interaction term for the case managed float is rather implausible, as it predicts monetization when the economy contracts. Inflation changes in conflict economies do not explain movements in monetization in any exchange regime.

After conflicts end, monetization again does not appear to be linked in a systematic fashion to economic activity in polar exchange regimes. However, in managed float economies monetization is lower after conflicts end, as indicated in the negative sign obtained for the
estimated coefficient. On the contrary, our evidence indicates that aid flows induce higher degrees of monetization in post-conflict economies if they have set up fixed or managed float exchange systems. Finally, inflation taxes in post-conflict countries do have differential impacts on monetization. There are no perceivable effects in fixed exchange rate countries, reflecting both the stability of inflation rates in these economies (as reported in Table 3) and the fact that agents care only for total holdings of currency and not for their composition in terms of domestic and foreign monies. In countries with managed floating exchange rates, there has been a significant re-monetization of the economy as a result of the inflation decline that characterizes post-conflict periods. Contrarily, in economies with purely floating exchange systems, the decline in inflation has also been accompanied by a reduction of monetary holdings, perhaps as a reflection of the fact that in countries with managed float systems households maintain rather large fractions of their wealth in foreign currencies, perhaps due to doubts about the ability of these countries to control inflation in the absence of a credible anchor.
<table>
<thead>
<tr>
<th>Table 9</th>
<th>Econometric Results: Monetary Holdings (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Log M1 (% of GDP)</td>
</tr>
<tr>
<td><strong>Standard Controls</strong></td>
<td></td>
</tr>
<tr>
<td>Real GDP (in logs)</td>
<td>0.006 (0.028)</td>
</tr>
<tr>
<td>Population (in logs)</td>
<td>-0.205 (0.067)***</td>
</tr>
<tr>
<td>Inflation (log (1+inflation rate))</td>
<td>-0.052 (0.020)***</td>
</tr>
<tr>
<td>Aid (% of GNI, in logs)</td>
<td>-0.002 (0.003)</td>
</tr>
<tr>
<td><strong>Additional Controls</strong></td>
<td></td>
</tr>
<tr>
<td>Interaction 1: Conflict*Real GDP</td>
<td></td>
</tr>
<tr>
<td>Fixed Exchange Rate</td>
<td>-0.007 (0.012)</td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>-0.014 (0.007)***</td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td>0.002 (0.089)</td>
</tr>
<tr>
<td>Interaction 2: Conflict*Aid</td>
<td></td>
</tr>
<tr>
<td>Fixed Exchange Rate</td>
<td>-0.005 (0.009)</td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>0.033 (0.010)***</td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td>0.013 (0.033)</td>
</tr>
<tr>
<td>Interaction 3: Conflict*Inflation</td>
<td></td>
</tr>
<tr>
<td>Fixed Exchange Rate</td>
<td>0.008 (0.107)</td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>-0.007 (0.072)</td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td>0.133 (0.2487)</td>
</tr>
<tr>
<td>Interaction 4: Post Conflict*Real GDP</td>
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</tr>
<tr>
<td>Fixed Exchange Rate</td>
<td>-0.007 (0.012)</td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>-0.014 (0.007)***</td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td>0.002 (0.089)</td>
</tr>
<tr>
<td>Interaction 5: Post Conflict*Aid</td>
<td></td>
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<tr>
<td>Fixed Exchange Rate</td>
<td>-0.005 (0.009)</td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>0.033 (0.010)***</td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td>0.013 (0.033)</td>
</tr>
<tr>
<td>Interaction 6: Post Conflict*Inflation</td>
<td></td>
</tr>
<tr>
<td>Fixed Exchange Rate</td>
<td>0.008 (0.107)</td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>-0.007 (0.072)</td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td>0.133 (0.248)</td>
</tr>
<tr>
<td>Constant</td>
<td>2.188 (1.292)***</td>
</tr>
<tr>
<td>Serial correlation test of order 1</td>
<td>-2.02***</td>
</tr>
<tr>
<td>Serial correlation test of order 2</td>
<td>0.18</td>
</tr>
</tbody>
</table>

Note: Number of countries=117, number of observations=653, maximum number of instruments=56, time dummies and country dummies included. (*, **, ***)= significant at 90%, 95% and 99% confidence, respectively.

**Inflation**

After the emergence of a consensus in the 1980s on the harmful effects of inflation, the last two decades have witnessed a marked reduction in inflation rates across the world. Empirical evidence collected from large cross-country analyses and numerous case studies indicated that the negative effects of high and variable inflation on macroeconomic stability, economic growth, and income distribution largely outweigh the potential benefits derived from financing fiscal deficits through monetization. However, controlling inflation has not been an easy task and
monetary policies have largely been coordinate to exchange regimes. Some countries have resorted to fixing the exchange rate in order to curtail the growth in nominal prices. Others have implemented harsh monetary policies under floating exchange rates. Calvo and Vegh (1999) study these stabilizations attempts and conclude that beyond an initial boost to economic activity, these policies tend to appreciate the currency—even when policies are credible—, raise interest rates, and worsen the current account and the balance of payments. It is thus useful to study the case of post-conflict economies that, in addition to the difficulties of post-war economic reconstruction, had to deal with substantial aid flows and/or currency misalignment.

Based on previous research on the determinants of inflation we posit an empirical dynamic model of the form:

\( \pi_{it} = \alpha \pi_{i,t-1} + \beta' X_{it} + \mu_i + \lambda_t + \epsilon_{it} \)

where \( \pi_{it} \) is the annual inflation rate, \( X_{it} \) is a vector of fundamentals and, as before, \( \lambda_t \) is a period-specific effect, \( \mu_i \) represents unobserved country-specific factors, and \( \epsilon_{it} \) is the regression residual. As in the previous section, we estimate a dynamic panel-data model of inflation using 500 observations from around 110 countries.

**Inflation Determinants**

With regards to the fundamentals, we follow De Brouwer and Ericsson (1998) and others and posit a cost based explanation for the long-run course of consumer prices in the countries of our sample, which we extend to consider the role of active monetary policies. We thus include variables reflecting the state of the aggregate demand (which we proxy using the real interest rate) and the cost of domestic vs. imported production goods (which we proxy using the real exchange rate).

We also include a dummy to recognize the effect of monetary policies with an explicit inflationary target. This relatively novel scheme for monetary policy conduct has been positively appraised by several studies. An early cross-country study by Corbo et al. (2002) concludes, on the basis of a variety of econometric models, that inflation-targeting countries perform consistently better than the control group in terms of controlling inflation and, most importantly, without inducing additional volatility in output. Some 25 countries are inflation targeters in our sample.

In addition, since we work with a sample of heterogeneous countries with very different institutional frameworks, we control for more structural variables such as the level of development (which we proxy with per-capita GDP at PPP levels), the degree of openness of the capital account, and the depth of the financial sector. Finally, we include as a regressor the flows of foreign aid as ratio to GDP, on the grounds that its presence influences aggregate demand and, evidently, inflation. Because we include time-specific dummies, we can effectively control for the world economic inflation and their transmission to each country’s performance.

**Estimation Results**

The results are collected in Table 10. Column 1, which corresponds to the baseline regression, indicates that inflation tends to decline—as expected—ith higher degrees of development of the financial sector, higher openness of the capital account, tight monetary policy as reflected in a high real interest rate and when central banks adopt an inflation targeting scheme for monetary...
policy. Aid flows only have a very mild inflationary effect. Note that RER undervaluation (overvaluation) leads to higher (lower) inflation, which could be the result of the attempt by monetary authorities of using a rigid nominal exchange rate as a tool for stabilization. This latter observation prompts us to extend our base model to include dummy variables for testing whether exchange regimes make some difference on inflation levels. The results in column (2) indicate that countries with fixed or managed float exchange regimes tend to have lower inflation levels. Note also that at the same time the estimated coefficient for RER undervaluation is now insignificant. This would suggest that monetary authorities intervene in the foreign exchange market to control inflation even at the cost of incurring a currency overvaluation that, as discussed in the previous section, could be costly to economic recovery.
### Table 10
**Econometric Results: Inflation (annual %)**

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Standard Controls</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Initial Real GDP per capita (in logs)</td>
<td>0.467 (0.164)***</td>
<td>0.295 (0.154)*</td>
<td>0.293 (0.154)*</td>
</tr>
<tr>
<td>Capital Account Openness (Ito-index)</td>
<td>-0.209 (0.049)***</td>
<td>-0.149</td>
<td>-0.154 (0.046)***</td>
</tr>
<tr>
<td>Inflation Targeting (Dummy)</td>
<td>-0.450 (0.195)**</td>
<td>-0.521</td>
<td>-0.504 (0.176)***</td>
</tr>
<tr>
<td>Real Interest Rate (% ex-post)</td>
<td>-0.957 (0.404)***</td>
<td>-1.138</td>
<td>-0.646 (0.387)</td>
</tr>
<tr>
<td>Financial Development (log private credit)</td>
<td>-0.513 (0.169)***</td>
<td>-0.362 (0.158)**</td>
<td>-0.371 (0.159)**</td>
</tr>
<tr>
<td><strong>Additional Controls</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RER undervaluation (log dev. from HP trend)</td>
<td>0.022 (0.012)*</td>
<td>0.008 (0.012)</td>
<td>0.024 (0.012)**</td>
</tr>
<tr>
<td>Aid (% of GNI, in logs)</td>
<td>0.020 (0.011)*</td>
<td>0.013 (0.010)</td>
<td>0.012 (0.011)</td>
</tr>
<tr>
<td><strong>Exchange Regime</strong></td>
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<td></td>
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<tr>
<td>Fixed Exchange Rate</td>
<td>-1.419 (0.511)***</td>
<td>-1.405 (0.505)***</td>
<td></td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>-0.999 (0.493)**</td>
<td>-0.945 (0.487)***</td>
<td></td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td>0.210 (0.474)</td>
<td>0.182 (0.466)</td>
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</tr>
<tr>
<td><strong>Interaction 1: Conflict*Aid</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed Exchange Rate</td>
<td>0.050 (0.023)**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>-0.005 (0.026)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td>0.578 (0.360)*</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Interaction 2: Conflict*RER undervaluation</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Fixed Exchange Rate</td>
<td>0.026 (0.064)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>-0.038 (0.052)</td>
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<td></td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td>0.044 (0.073)</td>
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<tr>
<td><em><em>Interaction 3: Post Conflict</em> Aid</em>*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed Exchange Rate</td>
<td>-0.015 (0.014)</td>
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</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>0.000 (0.015)</td>
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<td></td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td>-0.647 (0.262)***</td>
<td></td>
<td></td>
</tr>
<tr>
<td><em><em>Interaction 4: Post Conflict</em> RER undervaluation</em>*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed Exchange Rate</td>
<td>-0.058 (0.080)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managed Float Exchange Rate</td>
<td>-0.024 (0.055)</td>
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<td></td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td>-0.554 (0.489)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Constant</strong></td>
<td>-6.093 (1.482)***</td>
<td>-3.802 (1.497)***</td>
<td>-3.439 (1.48)***</td>
</tr>
<tr>
<td>Serial correlation test of order 1</td>
<td>-5.66***</td>
<td>-5.54***</td>
<td>-5.56***</td>
</tr>
<tr>
<td>Serial correlation test of order 2</td>
<td>-0.79</td>
<td>-0.76</td>
<td>-0.38</td>
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</tbody>
</table>

Note: Number of countries=107, number of observations=498, maximum number of instruments=54, time dummies and country dummies included. (*,**,***)= significant at 90%, 95% and 99% confidence, respectively.

We supplement our previous specification with interaction terms with the aim of studying the existence of differential indirect effects of fundamentals in the conflict and post conflict periods. We concentrate again on the impact of the inflationary impact of RER undervaluation when compounded with aid flows. The specification is thus:

\[
\pi_{it} = \alpha \pi_{it-1} + \beta'X_{it} + \gamma D_j + \theta_j D_j RERunderval_{it} + \varphi_j D_j AID_{it} + \mu_i + \lambda_t + \varepsilon_{it}
\]
The results in column 3 of Table 10 indicate that there is evidence to support the notion that external aid during conflicts has an inflationary impact on economies with polar exchange regimes, even if one controls for the eventual overvaluation (negative undervaluation) of the currency induced by aid flows (interaction 1). From an economic viewpoint, nevertheless, only the effect in countries with floating exchange rates is significant. Note also that there are no indirect effects of RER undervaluation, as all coefficients in the interaction 2 are insignificant. On the other hand, external aid given to countries with floating exchange regimes after conflicts end, tend to support stabilization efforts as indicated in the negative estimated coefficient in interaction 3 of Table 10.

CONCLUSIONS

This paper contributes to the macroeconomic agenda of post-conflict reconstruction by addressing the relatively under-researched area of monetary policy and exchange rate regimes. Specifically the paper asks whether the choice of exchange rate regime matters for aid effectiveness in promoting rapid growth and restoring macroeconomic stability. In this context the paper considers three broad exchange rate regimes: fixed, managed and floating. The experience of 38 countries that endured onset and end of civil wars during 1970-2008, suggests that the post-conflict performances of the fixed and managed regimes were very similar, and was superior to that of the floating regime. In terms of per capita GDP growth, the median country grew by 3.0 and 2.7 percent under the fixed and managed regimes, respectively; compared to the slightly lower 2.1 percent for the floating regime. Similarly for exports, while they grew by 7.8 and 7.6 percent, respectively, under the former two regimes; growth under the floating regime was much lower at 5.2 percent. The same story carries over to the re-monetization of private economic activities and inflation. While inflation was in single digits under the fixed and floating regimes, it was more than 16 percent under the floating regime. Also, while the share of domestic credit to the private sector reached more than 20 percentage points of GDP under the two former regimes, it was less than 16 percent under the latter.

Although the preliminary evidence suggests that the fixed and managed regimes might have an edge in promoting post-conflict economic recovery and macro stabilization, a proper assessment requires formal modeling of the marginal contribution of the three regimes in fully specified models of the four pivotal macroeconomic variables: per capita GDP and export growth, the demand for money balances and inflation. The paper estimates extended versions of these models in a panel over 1970-2008 covering 132 countries, including the 38 post-conflict countries and 94 peaceful ones as a control group. The regressions results for the standard determinants of the four macroeconomic indicators are, of course, not new and are consistent with the evidence from the received literature. The new and, in our view, novel results relate to the findings associated with the impact of the exchange rate regimes, especially with regard to their interactions with aid and the real exchange rate.

Firstly, in post-conflict economies the exchange rate regime has no statistically significant direct effect on overall GDP growth and the demand for money, but the free floating regime has a significantly negative effect on export, while both of the fixed and managed regimes have direct stabilizing effects on inflation.

Secondly, as discussed earlier in this paper, we regard the interaction term between aid and RER undervaluation as the most appropriate metric for assessing the conditional aid effectiveness in “good” policy environment, given the centrality of tradable economic activities
for post-conflict growth. The estimated effect of this variable suggests that aid was very effective in promoting growth under the fixed and managed regimes, provided that the authorities manage to engineer an RER undervaluation in the aftermath of civil wars. On the other hand, the combination of aid and undervaluation has had a negative impact on growth under the floating regime. This latter result may reflect the dominance of the non-tradable sector in the few post-conflict economies (only nine out of 40) adopting fully floating exchange rate regime.

Thirdly, on the other hand, the post-conflict aid-undervaluation effect was found to be positively associated with export growth under the managed and floating regimes, while it has a negative impact under the fixed regime. However, the latter effect is not economically meaningful, with a rather minuscule order of magnitude.

Fourthly, aid was found to help restore the post-conflict demand for broad money (M2) under all three regimes, while it would promote the demand for narrow money (M1) only under the managed and floating regimes. Instead, aid was found to have a deleterious effect on the M1 demand for the case of fixed regime.

Finally, aid has no direct effect on post-conflict inflation under the fixed and managed regimes, while it was found to have a stabilizing impact under the floating regime.

In conclusion, the above evidence suggests that the free floating exchange regime is not appropriate for countries coming out of civil wars. On the other hand, though these countries appear to do almost just as well under the other two regimes in terms of growth and inflation; the managed regime appears to have an edge on some critical areas of economic performance. First, under the managed regime aid promotes post-conflict exports and helps restore the demand for money balances. Second, due to its positive influence on exports, aid under the managed regime is likely to be a more reliable growth fundamental than under the fixed regime. Moreover, also because it promotes the demand for money under managed float, the monetary reconstruction role of aid (à-la Adam et al, 2008) is likely to be more effective under this exchange rate regime. The indirect impact of aid under managed float is important because aid was not found to have a direct effect on inflation under the two less flexible regimes, while it tends to directly reduce inflation under the floating regime. Third, the estimated aid effectiveness on output and export growth is conditional on RER undervaluation. However, engineering an RER undervaluation is rather difficult under a fixed exchange rate regime. Indeed, the real exchange rate literature suggests that, compared to managed floating regimes, the data shows a much higher frequency of RER overvaluation episodes under fixed exchange rate regimes (e.g. Elbadawi et al, 2007). This is explained by the recent evidence from the open economy macroeconomic literature that suggests that nominal and real exchange rates tend to track each other very closely for a few years (e.g. Levy-Yeyati and Sturzenegger, 2007). The implication of these findings is that the RER is likely to be directly influenced by nominal exchange rate policy, at least for the short-to-medium terms. Therefore, since the nominal exchange rate is a policy instrument under the managed regimes, while it is not under the hard fixed regimes, aid cannot be effective for post-conflict countries under the latter.
REFERENCES


## Appendix Table 2
### Main Macroeconomic Indicators of Short and Long Term Conflict Economies

<table>
<thead>
<tr>
<th></th>
<th>All Conflicts</th>
<th>Short Duration Conflicts</th>
<th>Long Duration Conflicts</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Economic Growth</strong> (annual change in real GDP per capita)</td>
<td>0.3</td>
<td>-2.8</td>
<td>1.0</td>
</tr>
<tr>
<td><strong>Labor Productivity Growth</strong> (real GDP at PPP Prices per worker)</td>
<td>0.1</td>
<td>-2.0</td>
<td>0.4</td>
</tr>
<tr>
<td><strong>Annual Inflation Rate</strong> (for the median country)</td>
<td>11.5</td>
<td>9.7</td>
<td>11.3</td>
</tr>
<tr>
<td><strong>Money</strong> (M2 as percent of GDP)</td>
<td>106.5</td>
<td>451.7</td>
<td>32.8</td>
</tr>
<tr>
<td><strong>Domestic Credit to Private Sector</strong> (average, as percent of GDP)</td>
<td>25.3</td>
<td>18.0</td>
<td>26.9</td>
</tr>
<tr>
<td><strong>Government Revenue</strong> (average, as percent of GDP)</td>
<td>18.9</td>
<td>14.0</td>
<td>20.0</td>
</tr>
<tr>
<td><strong>Military Expenditures</strong> (average, as percent of GDP)</td>
<td>3.2</td>
<td>2.7</td>
<td>3.3</td>
</tr>
<tr>
<td><strong>Exports</strong> (average, as percent of GDP)</td>
<td>23.3</td>
<td>22.7</td>
<td>23.5</td>
</tr>
<tr>
<td><strong>Merchandise Trade</strong> (average, as percent of total exports)</td>
<td>40.0</td>
<td>38.3</td>
<td>40.3</td>
</tr>
<tr>
<td><strong>External Aid</strong> (average, as percent of GDP)</td>
<td>5.5</td>
<td>8.9</td>
<td>4.7</td>
</tr>
<tr>
<td><strong>Foreign Direct Investment</strong> (average, as percent of GDP)</td>
<td>1.4</td>
<td>1.0</td>
<td>1.5</td>
</tr>
</tbody>
</table>

Source: own elaboration based on IMF and World Bank data (see Appendix A)
## Appendix A: Definitions and Sources of Variables Used in Regression Analysis

<table>
<thead>
<tr>
<th>Variable</th>
<th>Definition</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP per capita</td>
<td>Ratio of total GDP to total population. GDP is in 2005 PPP-adjusted US$</td>
<td>World Development Indicators (2009)</td>
</tr>
<tr>
<td>Population</td>
<td>Total population</td>
<td>World Development Indicators (2009)</td>
</tr>
<tr>
<td>Normalized Inflation Rate</td>
<td>CPI inflation rate/(1+CPI inflation)</td>
<td>World Development Indicators (2009).</td>
</tr>
<tr>
<td>Domestic credit to the private sector (% of GDP)</td>
<td>Ratio to GDP of the stock of claims on the private sector by deposit money banks and other financial institutions.</td>
<td>World Development Indicators (2009).</td>
</tr>
<tr>
<td>Tax Revenue</td>
<td>Ratio of total tax revenue to GDP at current prices.</td>
<td>International Financial Statistics.</td>
</tr>
<tr>
<td>Exports</td>
<td>Ratio of total tax revenue to GDP at current prices.</td>
<td>World Development Indicators (2009).</td>
</tr>
<tr>
<td>External Aid</td>
<td>Ratio of official development assistance to GDP (both in current US$)</td>
<td>World Development Indicators (2009).</td>
</tr>
<tr>
<td>Foreign Direct Investment</td>
<td>Ratio of official development assistance to GDP (both in current US$)</td>
<td>World Development Indicators (2009).</td>
</tr>
<tr>
<td>Dollarization</td>
<td>In-shore deposit dollarization in the financial sector as ratio to GDP.</td>
<td>From Levy Yeyati (2006)</td>
</tr>
<tr>
<td>Exchange Rate Regime Classification</td>
<td>Fixed exchange systems include dollarization, currency boards, and monetary unions. Intermediate systems include from crawling pegs to managed floats. Other systems are considered free floats.</td>
<td>Author’s calculations, based on data from Reinhart and Rogoff (2004)</td>
</tr>
<tr>
<td>Initial output gap</td>
<td>Difference between the log of actual GDP and (the log of) potential (trend) GDP around the start of the period. The Hodrick-Prescott filter is used to decompose the log of GDP.</td>
<td>Author’s calculations, based on data from World Development Indicators (2009).</td>
</tr>
<tr>
<td>Gross secondary-school enrollment</td>
<td>Ratio of total secondary enrollment, regardless of age, to the population of the age group that officially corresponds to that level of education.</td>
<td>Barro and Lee (2010) and World Development Indicators (2009).</td>
</tr>
<tr>
<td>Trade Openness (% of GDP)</td>
<td>Residual of a regression of the log of the ratio of exports and imports (in 2005 US$) to GDP (in 2005 US$), on the logs of area and population, as well as dummies for oil-exporting and landlocked countries.</td>
<td>Author’s calculations, based on data from World Development Indicators (2009).</td>
</tr>
<tr>
<td>Variable</td>
<td>Description</td>
<td>Source</td>
</tr>
<tr>
<td>----------</td>
<td>-------------</td>
<td>--------</td>
</tr>
<tr>
<td><strong>Main telephone lines per 1,000 workers</strong></td>
<td>Telephone lines connecting a customer's equipment to the public switched telephone network. Data are presented per 100 population for the entire country.</td>
<td>World Development Indicators (2009)</td>
</tr>
<tr>
<td><strong>Systemic banking crises</strong></td>
<td>Number of years in which a country underwent a systemic banking crisis, as a fraction of the number of years in the corresponding period.</td>
<td>Author’s calculations, based on data from Laeven and Valencia (2008)</td>
</tr>
<tr>
<td><strong>Terms-of-trade shocks</strong></td>
<td>Measured as the deviation of the actual terms of trade from its long-run trend computed using the Hodrick-Prescott filter. Terms of trade are defined as customary.</td>
<td>Author’s calculations, based on data from World Development Indicators (2009).</td>
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<tr>
<td><strong>Real Exchange Rate Misalignment</strong></td>
<td>Measured as the deviation of the actual RER from its equilibrium computed using the Hodrick-Prescott filter.</td>
<td>Author’s calculations, based on data from World Development Indicators (2009).</td>
</tr>
<tr>
<td><strong>Money M1</strong></td>
<td>Currency and demand deposits outstanding at the end of the year as percentage of GDP.</td>
<td>International Financial Statistics.</td>
</tr>
<tr>
<td><strong>Money M2</strong></td>
<td>M1 plus currency and demand deposits outstanding at the end of the year.</td>
<td>International Financial Statistics.</td>
</tr>
<tr>
<td><strong>Price Level</strong></td>
<td>End-of-year consumer price index (CPI).</td>
<td>World Development Indicators (2009).</td>
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<tr>
<td><strong>Interest Rate</strong></td>
<td>Nominal interest rate offered for demand deposits, end-of-period.</td>
<td>International Financial Statistics.</td>
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<tr>
<td><strong>Nominal Exchange Rate</strong></td>
<td>End-of-period nominal exchange rate, local currency per US$ dollars.</td>
<td>International Financial Statistics.</td>
</tr>
<tr>
<td><strong>International Interest Rate</strong></td>
<td>LIBOR nominal interest rate.</td>
<td>Author’s calculations, based on data from International Financial Statistics.</td>
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<td><strong>Period-specific shift</strong></td>
<td>Time dummy variable.</td>
<td>Authors’ construction.</td>
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### Appendix B: Countries included in the sample

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<td>Brazil</td>
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Foreign assistance and the political economy of post-conflict countries

Philip Keefer

Aid to post-conflict countries ideally supports reconstruction and humanitarian assistance, long term development, and the emergence of sustainable peace. Realizing this ideal is difficult: strategies for achieving the three objectives may be mutually exclusive; political economy constraints that obstruct development and increase conflict risk are particularly hard for the donor community to address; and development aid alone may be insufficient, or entirely ineffective, unless accompanied by security assistance. The central argument of this paper is that political market imperfections—country characteristics that distort the incentives of political actors both to pursue development and to mitigate the risks of conflict—should play a central role in the design of aid programs to post-conflict countries.

For example, a typical priority of development aid is to support reconstruction and humanitarian needs—replacing devastated infrastructure, fighting a conflict-induced HIV epidemic, or putting in place a coherent monetary policy. These aim to reverse the damage wrought by conflict. If one believes that the experience of conflict itself, with its proximate consequences, are the main factors driving post-conflict development and the prospects for sustainable peace, the reconstruction priority is understandable. However, even before conflict, most conflict countries exhibited political market imperfections that were favorable neither to development nor (obviously) peace. Unless conflict has fortuitously swept away the pre-conflict sources of slow development and high conflict risk, reconstruction assistance may be insufficient to put post-conflict countries on a path to sustainable development and peace.

Focusing on the tension between pursuing peace objectives and pursuing development, Boyce (2008) concludes, as well, that tradeoffs are frequent and non-trivial. In the first years after reconstruction started in Cambodia in 1979, multilateral assistance focused on fiscal stability and a civil service more appropriately sized to its responsibilities and capabilities. The government of Cambodia, however, rather than cutting the civil service by 20 percent, increased it by 15 percent, viewing civil service jobs as essential for political stability. In Iraq, foreign advisors pushed heavily for the cancellation of a food distribution program instituted under the Saddaam Hussein regime, which guaranteed every Iraqi household a basket of food rations. While inefficient and prone to leakage, the program was one of the few policy instruments for which the government could get credit: people were informed about what was due them and could easily monitor government compliance with the policy. The program was therefore retained (author observation). In these cases, the donor model of post-conflict development rested on certain principles of fiscal policy. Apart from the absence of evidence suggesting that fiscal policy was the appropriate issue on which to focus, the reforms foundered on the political market imperfections that drove inefficient government policies.

More generally, the development model pursued by donors in post-conflict settings operates under the premise that development is a correlate of conflict and that any exogenous boosts to economic growth also reduce conflict risk. This conclusion is intensely debated, however, with the counter-argument that underlying conditions in countries promote both development and peace. World Bank (2003) concludes that conflict is significantly less likely in richer countries, and Collier and Hoeffler (2004) argue that substantial aid reduces the risk of conflict recurrence, but Suhrke, Villanger and Woodward (2005) contend that this result is not robust to small changes in sample and specification. Keefer (2008) shows that income bears little
relationships to conflict if one considers only the countries with less than median income per capita—that is, the group of countries within which 85 percent of conflicts occur. Miguel, Satyanath and Sergenti (2004) focus only on Africa and do show that income declines, instrumented by rainfall, increase the probability of conflict. However, these conflicts emerge in precisely those environments where drought-induced resource conflicts are most likely: where governments have weak incentives to protect the rule of law.

Instead, Keefer and Khemani (2005) outline a range of political market imperfections that distort decision making and deter politicians from pursuing the broad public interest. These include the inability of political competitors to make broadly credible promises to citizens, imperfectly informed citizens, and social polarization. These same imperfections increase the probability of conflict. Keefer (2008) argues that the inability of political actors to make broadly credible promises to citizens is both a disincentive to pursue growth-promoting policies and a significant impediment to the formation of effective counter-insurgency capacity and that social polarization itself is more likely when politicians cannot make broadly credible appeals to citizens. De Figuereido and Weingast (1999) and many others point to imperfect information as an essential ingredient in conflict. Political market imperfections are likely to be most acute in post-conflict countries. To the extent that they are key to both development and conflict, development assistance that does not address them will have little effect on either post-conflict peace or development.

This chapter reviews the role of political market imperfections in post-conflict countries and the effects that these are likely to have on both development and conflict. It makes three points. First, the effects of these imperfections are large. Second, donor strategies in post-conflict countries tend to ignore these imperfections. Third, it is reasonable to abstract from the fact of conflict, focusing instead on underlying factors that increase the risk of conflict, when designing policies in post-conflict settings.

The conclusion points to specific modalities of development assistance that are likely to be most successful in the politically difficult setting of post-conflict countries, as well as to the types of assistance (mostly institutional, but also financial and capacity-related) that can mitigate political market imperfections. Donor strategies can do more to address the underlying political economy circumstances that both make conflict more likely and undermine development objectives. In many cases, this will involve what Boyce (2008) calls “peace conditionality”: linking the disbursement of assistance to recipient efforts to sustain peace. However, discussions of “peace conditionality” focus on what is needed to get combatants to stop fighting; the discussion here suggests a broader focus, critical to the sustainability of both development and peacemaking efforts, on the incentives of post-conflict rulers to serve the interests of citizens broadly.

**SUSTAINABLE DEVELOPMENT AND PEACE: THE CHALLENGE OF POLITICAL MARKET IMPERFECTIONS**

Government decisions play a large role in both economic development (restraining predation and providing public goods that support investment and job creation), and in sustaining the peace (building up counter-insurgency capacity and ensuring high levels of citizen satisfaction). However, governments frequently have weak incentives to pursue these two goals. Political market imperfections—factors that interfere with the ability of the general public to hold politicians accountable for their pursuit of the broad public interest—are at the core of these
incentives (Keefer and Khemani 2005). In all fragile countries, and especially in post-conflict countries, political market imperfections are particularly likely to deter political decision makers from pursuing public policies in the public interest—including policies that accelerate economic development. Foreign assistance generally, but especially in post-conflict countries, is less likely to succeed to the extent that it fails to take political market imperfections into account.

Five imperfections are key: uninformed citizens; non-credible politicians and its corollary, citizens who are unable to act collectively to sanction politicians who renege; social polarization; violence; and capacity constraints. These last three are well-known in post-conflict settings. The discussion here outlines the consequences of these political market imperfections for the tradeoffs that donors confront in post-conflict countries.

**Uninformed citizens**

When citizens lack information about politician actions and how they affect citizen welfare, they cannot easily hold politicians accountable for unfavorable outcomes. Politicians are not only more likely to shirk, however. In a low-information environment, they also disfavor policies that are complex and for which citizens cannot easily observe the politician contribution; they are more likely to favor policies that allow them to deliver, directly, concrete, tangible benefits to citizens. One would expect worse development outcomes where the number of media outlets is low, where their control is concentrated, and where the share of government-owned media outlets is high. These are all characteristic of post-conflict countries.

Assistance to post-conflict countries rarely addresses the information gaps confronting citizens. On the contrary, when post-conflict governments impose limits on the media or refuse to divulge information required to hold them accountable, donors often say little, believing that this is related to the “democracy” agenda, not to the development or post-conflict agenda. The opposite is true, however, to the degree that governments that operate behind a curtain are less likely to pursue development and are more difficult for opponents to trust.

**Non-credible politicians and citizens who are unable to act collectively**

Politicians who cannot make broadly credible promises have limited incentives to pursue the public interest and ample incentive to pursue the interests of narrow groups in society, including their own. In non-credible environments, the politics of clientelism prevails. These undermine development because they encourage political decision makers to engage in rent-seeking and to make narrowly targeted, clientelist decisions at the expense of public policies that improve the welfare of all citizens (Keefer and Vlaicu 2008). Moreover, politicians who have fewer incentives to pursue the public interest are more likely to place restrictions on the media.

The ability of citizens to act collectively to sanction politicians who break their promises is central to the ability of politicians to make credible commitments. The logic of political market imperfections is therefore as important in non-democracies as in democracies. Of 68 conflicts that ended from 1975–2000, only 29 had competitively-elected governments in place two years after the conflict. Either the legislature or the executive, but not both, were competitively elected in eight countries. In the remaining 31 countries, elections were either not held or were tightly controlled.²³⁶ However, as Keefer and Gehlbach (2011) demonstrate, autocrats who allow some citizens (e.g., members of the ruling party) to engage in collective action—including acting

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collectively if the autocrats renege on commitments to them—are also able to make credible commitments to those citizens.

In both democracies and autocracies, the capacity to make credible promises to citizens is closely tied to the presence of institutionalized political parties. Institutionalized parties are organized to allow collective action by party members to pursue the collective interests of party members, such as the pursuit of a policy program that party members favor, or protection from ruler expropriation. A key organizational feature of institutionalized parties is arrangements that reduce the costs to party members of acting to discipline the leaders, but also arrangements that prevent party members from shirking on their obligations to the party.

Absent institutionalized parties, citizens can only hold individual politicians accountable for policy failures. But since individual politicians are rarely able to make policy decisions by themselves, it is irrational for citizens to blame them when they fail to deliver better policies. In the presence of institutionalized parties, however, citizens can hold politicians collectively responsible for broad policy failures; politicians have incentives to pursue better public policies; and they have the capacity to credibly commit to pursuing such policies. Keefer (2011) presents evidence that institutionalized parties are associated with greater school enrollment, higher quality bureaucracy, and greater rule of law.

Institutionalized parties are difficult to build. In democracies, individual politicians who can rely on clientelist promises to narrow groups of voters are loath to give up on those promises in order to support the policies of a new party. Similarly, new parties are reluctant to require individual candidates with the ability to attract the votes of clients to refrain from making narrowly targeted, clientelist promises. In non-democracies, leaders frequently feel more secure when they can establish multiple, competing security forces and imposing strict controls on the flow of information. That is, they prefer to make collective action by regime supporters more difficult, not less difficult. As Gehlbach and Keefer (2011) describe, Mao took numerous steps that made collective action by Chinese Communist Party members difficult. After his death, however, and corresponding to the period of significant prosperity in China, the leadership of the Communist Party institutionalized it, allowing greater information transmission among party members and greater coordination among them, and established more transparent conditions for cadre advancement inside the party.

Keefer (2008) provides evidence that, in countries where political parties are not institutionalized and political competitors are unable to make broadly credible promises to citizens, conflict is more likely. He attributes this to the inability of governments in such settings to mount an effective counter-insurgency. For example, a well-functioning police force and army are key to counter-insurgency, but clientelist politicians have little ability or incentive to ensure that these emerge. They also have limited incentives to make public policies that benefit citizens generally, reducing citizen opposition to insurgent movements.

The importance of credibility and information for government decision making and economic development illuminates a number of tradeoffs in post-conflict development policy. Once concerns the role of elections. Though some donors have urged rapid adoption of elections in post-conflict countries to boost the legitimacy of governments, the World Development Report (2011) emphasizes the risks and instability of elections. Busumtwi-Sam (2002) argues that political liberalization, short of democracy, can provide the conditions for a sustainable post-conflict peace. The discussion here suggests that this debate may miss the key issue. The question is not whether governments are elected, but whether they support or undermine collective action by large groups of citizens. Elections in the midst of political market
imperfections do not address the substantive causes of civil war; authoritarian regimes that allow political and civil liberties bind themselves to better outcomes because they raise few barriers to collective action by potential opponents.

Another tradeoff is between the pursuit of development objectives, such as human development reforms or infrastructure, in the belief that these will trigger economic growth. In the presence of political market imperfections, though, these interventions are unlikely to have a significant development effect. Politicians with weak incentives to pursue development are unlikely to implement education reforms or undertake road maintenance.

**Polarization**

Social polarization is a well-known phenomenon in post-conflict countries. It has three effects. It weakens political competition, because individuals prefer leaders from their own group, regardless of performance, rather than leaders of other groups. This, in turn, attenuates politician incentives to pursue development, even for their own group. It weakens public support for broadly beneficial policies: individuals may prefer policies that make them worse off than reforms that would make both them and members of other groups better off. Finally, third, it creates mistrust: even if current policies treat groups equitably, individuals worry that when other groups obtain any slight political advantage, they will use their advantage to dismantle current policies.

Typical policy responses to minimize the effects of polarization do not address all three of these problems. Careful attention to inter-group equity in the distribution of positions in government and the benefits of government programs does not solve the problems of aversion to public goods and lack of credibility. Dividing ministries among key groups does not allow groups to block adverse decisions in any ministry that they do not control. On the contrary, each group exploits control of a ministry to deliver as many benefits to itself as possible in the shortest period of time at the expense of the others. Arrangements that grant explicit veto power over key government policies to each competing group is likely to produce gridlock.

Moreover, efforts to soften the effects of polarization without addressing obstacles to citizen collective action and uninformed citizens are likely to be ineffective. As long as these political market imperfections are present, political competitors are more likely to make ethnic or sectarian appeals that deepen divisions, or create divisions where none previously existed.

**Violence and insecurity**

The threat of violence looms large in most post-conflict countries. Either the resurgence of conflict remains a threat because one group did not decisively defeat the other, or a state of lawlessness prevails in which crime and, especially, organized criminal groups predate on citizens. Obviously, all development objectives, from infrastructure provision and private investment, to education and health service delivery, are more difficult to elicit when violence is endemic. However, violence also has important implications for political incentives in post-conflict settings.

First, post-conflict political decision making institutions may be designed to privilege combatants. As is well-known (e.g., Azam 2008), sustainable peace requires credible agreements between combatants, and credibility emerges only if the parties to conflict retain their ability to mobilize violence. Such arrangements may be costly, however, and reduce the incentives of
political actors to pursue the broad public interest. Though such institutions are usually better for citizens than continued conflict, public policies that emerge from them favor combatants over citizens generally.

Second, citizens may be prevented, because of fear of violent retribution, from holding politicians accountable for their decisions. If non-performing incumbents rely on force to interrupt electoral or any other mobilization against them, their incentives to perform better are attenuated.

Third, lawlessness may be such that citizens judge politicians by how well they restore law and order and ignore performance on other margins, including those related to economic development. This dulls political incentives to improve development outcomes for citizens. Development objectives are more difficult to pursue not only because development is generally difficult where violence is high, but in particular, voters are less likely to hold politicians accountable for development success in the midst of violence.

Where violence prevails, it undermines all other activities of donors that are meant to promote development. Nevertheless, external actors do relatively little to address problems of violence, either in terms of committing forces to suppress government-insurgent conflict, or in supporting the reform of the police and criminal justice system. Although there is little disagreement that security needs are among the most pressing in post-conflict settings (Collier, Hoeffler and Söderbom 2004), data collected by Regan (2002) indicates that outside intervention by neutral forces interested in the long-run development of the conflict country is rare. Looking at 150 conflicts from 1945 to 1999, in 72 cases there was no outside intervention involving troops. The remaining 78 cases present a mixed picture in which, often, multiple intervenors, variably supporting the government, the opposition, or acting neutrally, were active. Moreover, Regan finds only nine cases in which outsiders intervened neutrally. International organizations intervened with troops in only 20 of the 150 conflicts.

In 2001-02, out of a total of US$2.8 billion that the UN spent on peacekeeping, two-thirds went to four conflicts: East Timor (US$477 million), the Democratic Republic of Congo (US$393 million), Kosovo (US$413 million), and Sierra Leone (US$699 million).\(^{237}\)

Nevertheless, in 2001, according to the database on conflict maintained by the Peace Research Institute of Oslo (PRIO), there were 28 internal conflicts and 36 conflicts altogether, eleven of which were coded as major (involving more than 1,000 deaths in 2001).

**Capacity constraints**

Capacity constraints are also more likely to be severe in post-conflict settings. Again, this is well-known. The already-educated who could implement development-promoting policies have often fled the country, while conflict deters the not-yet educated from acquiring further human capital. In East Timor, Rosser reports that of 160 doctors in the territory prior to war, only 30 remained after the Indonesians withdrew in 1999 (Rosser 2007, p. 126). The usual policy response is simply to boost capacity, using wage subsidies from donors to attract diaspora or other international talent into the country, to direct government resources (again, often subsidized by donors) to education, and to provide technical assistance and grants for institutional development.

These actions assume that governments desire to improve capacity and to utilize improved capacity in the delivery of services to citizens. In the absence of progress on other

political market imperfections, from lack of credibility to violence, this is unlikely to be the case. Moreover, these actions do not take into account that capacity constraints undermine political incentives to pursue a wide range of public policies—including the improvement of capacity! Knowing that any government confronts heavy capacity constraints on its ability to deliver public goods, citizens are more likely to favor candidates who can credibly promise other government benefits that are easier to deliver. This class of policies is more likely to include targeted benefits, such as food or other handouts, than the universal provision of primary school education and the improvement of the public administration.

**POLITICAL MARKET IMPERFECTIONS VERSUS DONOR STRATEGIES**

The foregoing argument summarizes claims that political market imperfections play a key role in both the development prospects of a country and their risk of conflict. Donor strategies, however, do not focus on political market imperfections. They do tend to treat post-conflict and at-risk, but non-conflict countries similarly. That is, the fact of conflict does not appear to have a large effect on development strategies in post-conflict countries compared to at-risk countries that never experienced conflict.

The World Bank, for example, places a significant priority on human development in poor countries. It pursues this priority in poor post-conflict countries, as in the Democratic Republic of Congo. Following the cessation of hostilities in 2002, and from 2003-2008, Bank lending to the DRC focused on human development requirements of the country. Of 22 loans, totaling more than US$2 billion, which comprise most of the loans approved by the Bank, almost half went to education and health spending (US$300 million of which was targeted to HIV-AIDS). About US$360 million went to emergency support and demobilization (totaling approximately US$35 million). About five percent went to governance and public sector management reforms (US$110 million) and about 15 percent to transport (US$325 million) (World Bank records). Apart from small amounts spent on demobilization, these priorities reflect the humanitarian concerns of donors and efforts to address the human development needs of a poor country. It is unlikely, for example, that the tragic AIDS epidemic in the DRC is a risk factor for conflict in the country, nor the most important obstacle to more rapid economic growth.

World Bank development strategies are different in more developed countries, but again abstract from political market imperfections. In post-war Bosnia and Herzegovina, from 1996 to 2003, more than twice as much Bank lending went to governance (US$135 million, or 13.7 percent of total World Bank lending, went to public sector governance) and about 55 percent went to growth-related activities (private sector development, energy and mining, transport, economic policy support, and the financial sector). Less than 8 percent of lending was directed at health and education (World Bank 2004).

Donor visions of how to achieve development are not necessarily consistent. For example, over the four year period ending August 15, 2006, the United States Agency for International Development had disbursed US$3.5 billion in Afghanistan. Social service delivery was a far lower fraction of total USAID assistance in Afghanistan than of World Bank lending to the Congo (less than 15 percent compared to almost 50 percent). Instead, including infrastructure, expenditures by USAID to accelerate economic growth in Afghanistan were of the same order, as a percentage of total activity, as the growth-oriented loans of the World Bank in Bosnia (FDCH Regulatory Intelligence Database; 8/15/2006, Item 32W3039193406).
As in the case of Bank lending to the DRC, the USAID strategy was grounded in a general belief that economic growth, *per se*, reduces conflict risk and infrastructure is key to economic growth. It did not emerge from a specific analysis of the political market imperfections in Afghanistan that perpetuate both slow development and high conflict risk.

In fact, a central feature of all development assistance in post-conflict countries is that it does not address the political market imperfections that systematically influence government incentives both to prevent the recurrence of conflict and to promote long-term economic development. Donors assume that the sources of conflict risk and slow development are rooted in weak service delivery and/or inadequate infrastructure. To the extent that political market imperfections are the main obstacle to peace and development, however, efforts to work through the service delivery/infrastructure channels are less likely to succeed.

One could respond to this concern by observing that, across the disparate environments of Afghanistan, the Democratic Republic of Congo and Bosnia and Herzegovina, donors have dedicated substantial resources and effort to institution-building. The focus has usually been limited to the government apparatus of a country (the public administration, possibly the judiciary) and the business of government (budgeting, the management of public sector finances, the recruitment and conditions of employment of the civil service). These activities are also sometimes called “state-building”, in the Weberian sense that focuses on the administrative apparatus of the state and not on its political underpinnings. However, as the analysis here makes clear, these activities are not sustainable and unlikely to succeed if they are not matched with corresponding efforts to enable citizens to hold governments accountable for their actions.

**WHAT MATTERS, THE EXPERIENCE OF CONFLICT OR BEING AT RISK OF CONFLICT?**

Whether one argues that the pillars of post-conflict development assistance should revolve around political market imperfections or around service delivery and infrastructure, the effect is to treat conflict countries similar to fragile states that have not experienced a conflict. The discussion of political market imperfections, while diverging from donor strategies in terms of what might matter most for peace and development, implies a similar conclusion with respect to the importance of conflict. With the exception of violence and capacity constraints, both of which are likely to be exacerbated by conflict, this is not necessarily the case for other political market imperfections. The fact of conflict, therefore, does not significantly influence development strategies.

This is counter-intuitive: one would expect the fact of conflict to have large implications for development strategies. However, some evidence supports this conclusion: development outcomes in post-conflict countries do not look significantly different than in non-conflict countries that exhibit a similar risk of conflict. Moreover, although the human costs of conflict can be unimaginably high, relatively little time elapses before post-conflict human development and economic indicators return to their pre-conflict levels. Manor (2008, p. 25) notes that while the devastation of large conflicts attracts significant emergency assistance, extreme emergencies rapidly give way to longer-term issues. This is because, while the economic situation of citizens in many post-conflict countries is desperate, desperation also marked their lives prior to conflict.

To see the speed with which the effects of conflict dissipate, Table 1 lists conflicts for which life expectancy data are available and demonstrates that average life expectancy in the third, fourth and fifth years after conflict is higher than life expectancy before conflict. The
Democratic Republic of Congo makes the case most starkly: life expectancy was terribly low after conflict, but also before.

Table 1: Life expectancy before and after conflict

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<tr>
<th>Country</th>
<th>First Year of Conflict</th>
<th>Propensity</th>
<th>Prewar GDPC</th>
<th>Life Expectancy Prewar</th>
<th>Postwar</th>
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<td>1177</td>
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<td>50.9</td>
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<td>496</td>
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<td>64.6</td>
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<td>0.012</td>
<td>2246</td>
<td>58.5</td>
<td>69.3</td>
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<td>0.088</td>
<td>1926</td>
<td>66.8</td>
<td>65.2</td>
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<td>Rwanda</td>
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<td>0.019</td>
<td>236</td>
<td>43.0</td>
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<tr>
<td>1990</td>
<td></td>
<td>0.027</td>
<td>250</td>
<td>44.5</td>
<td>36</td>
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<tr>
<td>Sudan</td>
<td>1963</td>
<td>0.057</td>
<td>297</td>
<td>40.6</td>
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<td>2325</td>
<td>57.1</td>
<td>68.9</td>
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<td>1979</td>
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<td>978</td>
<td>61.3</td>
<td>66.6</td>
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<td>238</td>
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<td>1997</td>
<td></td>
<td>0.027</td>
<td>171</td>
<td>51.6</td>
<td>50.6</td>
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<tr>
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<td>384</td>
<td>56.1</td>
<td>66.0</td>
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<tr>
<td>Yemen</td>
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<td>0.010</td>
<td>445</td>
<td>55.0</td>
<td>58.0</td>
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<tr>
<td>South Africa</td>
<td>1976</td>
<td>0.014</td>
<td>3316</td>
<td>53.9</td>
<td>51.6</td>
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<tr>
<td>DR Congo</td>
<td>1967</td>
<td>0.033</td>
<td>328</td>
<td>42.0</td>
<td>45.6</td>
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<tr>
<td>1976</td>
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<td>0.027</td>
<td>116</td>
<td>44.6</td>
<td>46.0</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>1983</td>
<td>0.015</td>
<td>642</td>
<td>59.9</td>
<td>60.7</td>
</tr>
</tbody>
</table>

Note: Data from *World Development Indicators*. Propensity scores are the probability of conflict, based on probit regressions of conflict occurrence on a number of independent variables (see text).

In addition, post-war outcomes in conflict countries are similar to those in countries that, before conflict onset, looked similar, but did not experience a conflict. Table 1 reports the propensity score for conflict countries: the probability that they would experience a conflict the year before conflict actually occurred. Propensity is calculated from a probit regression of civil war onset on real, purchasing power parity (ppp)-adjusted income per capita; government
consumption as a percentage of GDP, the fraction of the population that is rural, the fraction of the population under the age of 15, imports plus exports as a fraction of GDP, the fraction of land that is arable, total land area, the “stock of democracy” (years of democracy since 1900), ethnic fractionalization, and continent dummies. The score itself is simply the probability of civil war onset for a country the year before the actual civil war, based on the estimated coefficients of the probit regression and the country’s values of the independent variables in that year.

Table 2 compares conflict countries with non-conflict countries with similar propensity scores. To make the match more precise, among non-conflict countries with similar propensity scores, the comparison country is either the one the closest income per capita (Table 2a) or with the closest life expectancy (Table 2b).

The results in both tables 2a and 2b show that in the post-conflict period, life expectancy, bureaucratic quality (as measured in Political Risk Service’s *International Country Risk Guide*) and infant mortality are nearly the same in post-conflict countries and in the matching non-conflict country that, prior to conflict, exhibited a similar conflict propensity (and either similar income per capita or similar life expectancy). The most striking differences lie elsewhere: between conflict and matching countries, on the one hand, and the rest of the world. The conflict and non-conflict matching countries are much further below the world average with regard to life expectancy, bureaucratic quality and child mortality (not shown).

**Table 2: Conflict countries and matches: post-conflict averages.**

<table>
<thead>
<tr>
<th></th>
<th>Average of Conflict Country (N)</th>
<th>Average of Matched Country (N)</th>
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<tbody>
<tr>
<td>Life Expectancy</td>
<td>56.3 (25)</td>
<td>58.2 (25)</td>
</tr>
<tr>
<td>ICRG Bureaucratic Quality</td>
<td>2.25 (16)</td>
<td>2.41 (17)</td>
</tr>
<tr>
<td>Mortality (children under 5 years)</td>
<td>131 (25)</td>
<td>121 (25)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Average of Conflict Country (N)</th>
<th>Average of Matched Country (N)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life Expectancy</td>
<td>57.1 (19)</td>
<td>55.3 (19)</td>
</tr>
<tr>
<td>ICRG Bureaucratic Quality</td>
<td>2.25 (11)</td>
<td>2.15 (14)</td>
</tr>
<tr>
<td>Mortality (children under 5 years)</td>
<td>124 (19)</td>
<td>128 (18)</td>
</tr>
</tbody>
</table>

Note: Matched non-conflict countries are those with the closest GDP/capita (2a) or life expectancy (2b) among those countries with the most similar propensity scores. Propensity scores are calculated from a probit regression given in the text. Averages are of years three, four and five after the conflict. In some cases, one conflict/non-conflict country is the best match for more than one non-conflict/conflict country, respectively.

A more nuanced comparison is to look at the evolution over time of the conflict and matching non-conflict countries. From the sample in Table 2a, twelve conflict and twelve matching non-conflict countries can be compared with respect to the change in life expectancy from the year before conflict onset to the fifth year after conflict ended. Life expectancy actually rose 2.6 years in the conflict sample and only 1.5 years in the twelve non-conflict matching countries (1.2 years if the countries are matched as in Table 2b, using life expectancy). For only five conflict countries and five matching non-conflict countries can a similar comparison be made for bureaucratic quality, which dropped by .68 points for the five conflict countries, by .71 for countries matched as in Table 2a and by .51 for countries matched as in Table 2b.
CONCLUSION AND IMPLICATIONS FOR FOREIGN ASSISTANCE TO POST-CONFLICT COUNTRIES

The foregoing arguments make the point that political market imperfections condition the development and peace prospects of post-conflict countries and that foreign assistance in post-conflict countries should be designed to minimize the effects of these imperfections. They also condition the success of donors’ traditional efforts in these countries with respect to service delivery and infrastructure provision. Nevertheless, despite their importance, donors are typically reluctant or unable to address political market imperfections, especially in post-conflict countries. The exception is capacity constraints, but even here donors tend to ignore constraints in the security sectors.

If political market imperfections are beyond the capacity or remit of donors, then the appropriate strategy is to adapt assistance to the political market imperfections that are present. When political market imperfections are so severe that governments are incapable of serving citizen interests and, on the contrary, may be predating on citizens, only humanitarian assistance, provided by foreign donors directly, can have any effect on citizen welfare. There is no question of using government delivery mechanisms or of improving capacity. If levels of violence are too high, then even directly-provided humanitarian assistance will not be possible, the most obvious case of development work hinging on the willingness of external actors to commit forces to suppress violence.

In environments with less extreme political market imperfections, donors can rely on governments to channel foreign assistance to improve citizen welfare as long as the policy instruments are easily observable by citizens (politicians can get credit) and do not require high government capacity. Transfer payments and food handouts fall squarely into the class of interventions that meet these criteria. In contrast, efforts to improve the administrative machinery of government, such as the public sector financial management system, place much greater demands on citizen information and government capacity.

This should be a controversial recommendation. By several development criteria, handouts are bad policy: they are not targeted (everyone receives the handout); because of deadweight losses, the costs of raising revenues and of dispensing the handouts exceed the benefits received by citizens; and they do not directly increase citizen access to critical human development services. However, because the government commitment to provide universal handouts is easily observed and performance easily verified, programs to provide tangible universal benefits to citizens improve government credibility or legitimacy. They therefore support long-run development objectives and peace-building in a way that improved social service delivery (assuming it could be achieved) does not.

The donor agenda in post-conflict countries is generally more ambitious than this, including not only improvements in service delivery, but also accelerated economic growth and ambitious infrastructure construction programs. However, governments that confront significant political market imperfections are unlikely to use foreign assistance to promote these goals. The benefits of economic growth and improved service delivery are generalized, rather than confined to the narrow constituencies on which government support rests, and often hard for uninformed citizens to attribute to government action.

The development impact of donor interventions is evidently greater, then, to the extent that donors can assist countries in actually mitigating political market imperfections. The most
difficult of these is the control of violence. In many post-conflict countries (DRC, Afghanistan, etc.), security is the fundamental obstacle to peace and development. Where violence is not endemic, more choices are available. In the case of imperfect citizen information, donors have tractable policy instruments at their disposal, ranging from the sectoral (informing citizens of the amount of government transfers to individual schools) to the cross-cutting (support for initiatives that increase transparency in regulatory decision making). Donors can build performance measurement and dissemination into their assistance projects. To the extent that citizen information increases, and citizens have some mechanism to remove non-performing governments, donors can rely on governments to use assistance to improve citizen welfare.

To build up government credibility (or legitimacy) with citizens, donors should encourage the emergence of civil society organizations with the capacity to mobilize of citizens for collective action. This could include, for some donors, assistance to political parties to encourage them to build up the internal organizational arrangements that allow a large membership base to hold party leaders accountable.

Support to civil society organizations is common in post-conflict countries. The logic is usually different, though. Because government is often weak, donors sometimes prefer to deliver assistance through non-governmental organizations. However, in many post-conflict countries, non-governmental alternatives are also often scarce. Manor (2007, p. 26) argues that in only four countries, Bangladesh, Brazil, India and the Philippines, do NGOs have national networks and the ability to deliver services nationwide. For some key policy areas, non-governmental substitutes are simply not available: there is no non-governmental solution to arbitrary government decision making, the fear of expropriation, or a weak legal framework governing the financial sector.

The main argument against the use of non-governmental organizations is that it denies government an opportunity to build its capacity. In environments where governments have little incentive to build capacity in the first place, however, this objection is not persuasive. Moreover, if the binding constraint is country capacity, then building capacity in the non-governmental sector does not preclude the migration of that capacity to the public sector.

Universally, practitioners, researchers and observers call for modest ambitions in post-conflict settings (see, e.g., Manor 2007, p. 28). The argument in this chapter is no different, but the rationale for modesty differs. Manor emphasizes that large reform programs threaten powerful interests; the analysis here underlines the political incentives of governments to cater to vested interests rather than citizens more generally. For example, although high quality education and a level playing field for all firms are important for sustained economic growth, in countries where violence is endemic, or where citizens are poorly informed about government decision making, or where political competitors can make credible promises only to narrow groups of citizens (clients), it is not only vested interests, per se, that block reform. It is also the weak incentives of political actors, created by political market imperfections, to pursue reform.
REFERENCES


Powersharing and Conflict in Competition for Resources

Michael McBride, Gary Milante and Stergios Skaperdas

INTRODUCTION

Organized violence between actors over resources can take many forms, including civil wars, intertribal violence, violence over turf between rival gangs, common criminal violence, and violence between states over natural resources. Many forms of organized violence from this wide spectrum are exhibited by the cases in this volume. The tragedy of violence in competition over these resources is twofold: not only are there incentives for escalation in winner take all competitions as in the typical tragedy of the commons (Hardin, 1968), but there can also be loss of life and wasteful destruction as a result of violent competition. This chapter discusses how and when actors can regulate wasteful and destructive violent competition through institution building and “state-building”.

The causes of organized violence over resources and the reasons why it lasts are manifold and interconnected. The median length of a civil war in the post-World War II period has been more than seven years and persistence has been high as well (Collier et. al., 2003, p.80, World Bank, 2011). Many civil wars can have multiple, related causes and may evolve over time into other forms of violence, such that the ends of conflicts may be unrelated to the events that precipitated them. Conflicts can end with agreements or truce, they can simply fade away when actors stop investing in the conflict or they can end with one sided victory.

The causes of conflict and war (and solutions for avoiding it) have always been a subject of study, most recently in the social sciences through political philosophy, political science, sociology, anthropology, international relations and economics. Approaches in the economic literature to understanding the causes of conflict include incomplete or asymmetric information; indivisibilities or increasing returns on matters of contention; risk-seeking behavior; hate, revenge, and other preferential externalities; excessive optimism and wrong mental models of the world; and incomplete contracting or commitment difficulties. This article uses an economic approach to understand the relationship between conflict and the institutions that can be built to avoid it.

Not all reasons for conflict are as important at the end of conflict as at the start. As conflicts drag out over months and years, adversaries' incomplete information can be expected to subside, as should excessive optimism or incorrect mental models of the conflict. In some cases, indivisibilities can persist reducing the contracting space for peace agreements to nothing.

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238 This is very slightly revised version of McBride, Milante, and Skaperdas (2011). Copyright © 2011, SAGE Publications.
239 For overviews of explanations of conflict see Fearon (1995), Hirshleifer (1995), and Skaperdas (2006). For overviews of the economics of conflict and the literature on civil wars, respectively, see Garfinkel and Skaperdas (2007) and Blattman and Miguel (2010). A thoughtful discussion on how these models pertain to the sustainability of post-conflict peace can be found in Cunningham (2006).
240 This chapter draws on a more technical economic treatment of the subject in McBride, Milante and Skaperdas (2011). The first part of our model (on the choice between conflict and peace) is based on McBride and Skaperdas (2007, 2009), whereas the second part of the model (on investments in conflict management) is party inspired by Genicot and Skaperdas (2002). Kumar (2008) also examines a dynamic model of growth that incorporates investment in property rights.
Additionally, it is possible that hate and the urge for revenge could increase with time, fatalities, and atrocities and thus complicate a conflict’s ending. One persistent reason, however, that can cause conflict and perpetuate it is difficulties with trust or the absence of sufficient external enforcement in making adversaries abide by a peace agreement\textsuperscript{241}. That is, to phrase it differently, contracts on arming are difficult and costly to enforce and commitments to specific levels of arming can be difficult to implement.

Actual commitment environments in conflict-affected societies are not realistically reflected by discrete, “either-or” states, but lay on a continuum between the two extremes of the philosopher's state of nature (with “war of all against all” where there is no possibility of commitment) on the one hand, and “Platonic form” economic models in which property rights and commitments are perfectly and costlessly enforced on the other hand. In this chapter we are exploring that broad spectrum of commitment space which defines the agreements that can be reached and which agreements are not credible. In the real world, adversaries are typically able to make some limited commitments using third parties, social and political institutions that they have inherited from the past, or elements of the state that might have the independence and strength to partially guarantee peace agreements. Detailed power-sharing agreements, like those of Lebanon or Mozambique\textsuperscript{242} whereby different posts in the state are filled by the different contenting groups, can be considered as intermediate cases in which partial commitment can be achieved through measures that may be considered crude, inefficient, and overly intrusive from the outside but which can significantly reduce the reoccurrence of civil war.

As argued by North, Wallis, and Weingast (NWW, 2009), over the past two centuries, the modern state (and, more expansively, what NWW call the “open social order”) has taken the form of a long-lived entity that is able to make long-term commitments to a much greater degree than it could do in the past. The ability to commit can be considered a combination of laws, formal institutions, and informal institutions. A well-functioning bureaucracy, independent courts, non-corrupt police, non-involvement of the military in civilian affairs, separation of powers, checks and balances, reasonably independent press, long-lived private organizations, as well as norms of elite cooperation are attributes that contribute to the state's ability to commit. This is, however, still an ideal type that is not satisfied by a large majority of the states existing today. No low-income countries are anywhere close to satisfying the conditions of having such a state and their capacity to commit is rather limited. We argue that commitment can be built upon a type of collective good that has been variously described in the new institutional economics literature as governance, institutions, trust, social capital or bridging capital, property rights, or state capacity, the last term being the one we will be mostly using in this paper.

We pause here to note that there is an important distinction between the "State" as actor and the "state" as collective mental construct which includes: state functions, shared history and norms and, most importantly for our present purposes, the institutions which have developed over time and are identified with the functioning of the nation and society. Capacity is simply the capability or power to effect change, so it further follows that there is an important distinction between "State Capacity" - the strength or power of the "actor controlling the government" (the State) to effect change within borders, with neighbors or even to project power globally, and "state capacity", the effectiveness and legitimacy of the collective functions, norms and

\textsuperscript{241}Fearon (1995) first discussed the ideas associated with the problems of incomplete contracting, and dynamic models of the problem include Garfinkel and Skaperdas (2000) and Powell (2006). These enforcement issues as discussed specifically in the context of peace agreements are further developed in Werner and Yen (2005).

\textsuperscript{242} See Salti and Frangie, 2009 and Cadeado and Hamela, in this volume
institutions to deliver services (the state). One of the services delivered by a well-functioning state is conflict mediation and mitigation between actors and, so, we use the lower case term, "state capacity", to reflect the entirety of these mediation and mitigation capability, built over time. We hesitate in using the alternative terms "governance" or "institutions" because conflict mediation and mitigation require more than just the presence of a well-functioning bureaucracy - agreements can be based on informal, traditional, historical or customary arrangements which cannot be measured by the metrics often associated with governance or institutions.

To reiterate, we define building state capacity as the lengthy process of creating common understandings, norms, institutions and a culture of mediation which helps actors in a society avoid conflict. Often this is done initially through third parties, intermediaries or neutral parties. With time, the adversaries themselves could engage in actions that enhance their collective ability to commit. Instances of such actions range from the hiring of a (limited) external enforcer, the podesta, by rival clans in late Medieval Genoa (Greif, 1998) to the often drawn-out negotiations, confidence-building measures, and state-building that adversaries have engaged in more recent times. While the model we present here is one of “civil war” – a contest between two actors over control of resources within a state’s borders – the approach could be broadened to include interstate conflict over contested global commons (the regulatory framework would then be the global international system) or narrowed to look at subnational, intertribal, ethnic or violence associated with organized crime and the state would reflect local institutions present to mitigate conflict.

We first examine the conditions in which peace will prevail for a given, exogenous level of state capacity. That is, given a certain level of arming, each adversary compares expected payoffs from conflict against those of a peace agreement. Conflict has costs that may involve destruction and additional use of resources, but provides the chance of securing some portion of the contested commons. When this strategic interaction is repeated, it may be that victories now will lead to better strategic position in the future, and, as a result, lower expenditures by both sides to maintain their position (and more peace, though the “quality” of the peace for both sides may influence social welfare). Meanwhile, an armed peace avoids the destruction of conflict but could require, because of the commitment environment, the continued maintenance of some level of arming in order to maintain bargaining positions. As a result, the better the commitment environment, induced by what we’re calling state capacity, the lower the level of arming that each side would have to maintain in order to maintain peace.

In such a setup, peace becomes possible only when all parties to the agreement prefer it to continued conflict, and that is only possible when state capacity is above a critical threshold. The threshold level itself depends on the destruction and other possible extra costs of conflict but also on the discount factor, the shadow of the future. In particular, the effect of a longer shadow of the future tends to be a detriment to peace in the sense that state capacity's critical threshold becomes higher the higher is the discount factor.

We next explore the determinants of state capacity. In third section of the chapter, we consider three factors that could affect the degree of commitment through state capacity. First, 243 Credible, neutral and respected peacekeepers, mediators and observers from international and regional institutions can also fill the gap, creating commitment space for otherwise untenable agreements. We caution, though, that just as NGOs providing humanitarian aid can supplant local capacity to deliver social services, so too can international peacekeeping contribute to peace through building commitment space that does not reflect actual state capacity for commitments. Policymakers must ask, when peacekeepers leave, what state capacity has been built in country to deliver this commitment space? For more on the importance of aligning political missions and state capacity building to peacekeeping missions for success in peacebuilding, see Doyle and Sambanis (2000).
outside forces can intervene for good (third parties genuinely interested in peace) or bad (third parties that have an interest in the continuation in conflict or are biased toward changing the terms of an eventual peace in favor of one of the adversaries). Second, the degree of commitment depends on the history of interaction among the parties, with a longer history of conflict, mutual isolation, and distrust reducing the capacity for commitment. Finally, the adversaries themselves can engage in investments that improve state capacity for commitments.

In such an environment, adversaries invest in state capacity only when they expect to induce peace, although they will still engage in some arming given that commitment is never perfect. In this respect, our model captures the truly ambivalent nature of peace negotiations, where the actors grip the olive branch in one hand and the sword in the other. When adversaries expect war, there is no reason to invest in state capacity, and they instead concentrate resources on arming to enhance their probability of winning. This is consistent with our underlying assumptions that investments in state capacity for commitments can serve as credible signals of actors' belief in peace. Whereas the levels of investment in state capacity in equilibrium are unique, those are not necessarily the only levels of investment that might be expected to occur. It would be generally in the collective interest of both parties to engage in investments that are higher than those that would occur in equilibrium and if the parties could coordinate on higher levels they might be able to do so. The ability to coordinate on and implement such investments may well be a key factor for some countries in maintaining peace.

Another notable effect we find is that an increase in the value of the "prize" that is the object of contention between adversaries unambiguously increases investments in state capacity (except when these investments are already zero) and thus unambiguously enhances the payoffs under peace. If the value of the prize and income are correlated, then this result implies that we would expect higher income countries to have both higher state capacity and better prospects of peace, whereas lower income countries would tend to have lower levels of state capacity and more fighting. This is in line with the correlations observed (Collier et. al., 2003) but also with the attempts to disentangle causality. While intuitively plausible, the correlation between low income and conflict has been difficult to explain theoretically since the typical contest model of conflict (employed in section 2 below) shows a positive relationship between income and arming, with the latter considered a proxy for the amount of conflict present. Our dynamic model distinguishes between actual conflict vs. peace under the threat of conflict (in which there is still arming, ie. the difference between hot and cold wars). By introducing this distinction in the dynamic model, we no longer have to consider arming as a proxy for conflict. More importantly, not only do we find a relationship between income and conflict that is consistent with the empirical evidence but also we find a very plausible mediating mechanism: the incentive to invest more in state capacity for commitments when there is more income at stake (and more to be lost due to destruction). This is consistent with recent findings that weak political systems (proxied by anocracies, but possibly more reflective of young democracies) are more prone to conflict than established political systems and stronger bureaucracies (Fearon and Laitin, 2003, Keefer, 2009, Fearon, 2010).

Finally, we consider the possibility of the State as an actor while still maintaining our basic framework. In this model, the State may have outside support in arms, an advantage in conflict, and/or be the sole contributor to state capacity. In each formulation, the main logic of

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244 See Miguel et. al. (2004) for a careful treatment of causality in the relationship between income and civil war using data for African countries
the earlier part of our paper remains intact, though investments may now be more or less likely to occur depending on the exact setting.

**THE BASIC SETTING WITH EXOGENOUS STATE CAPACITY**

We consider the case of two groups, A and B, each contesting a rent (or, income) \( Y \) in each period over an indefinite time horizon. Although one of the groups can be a government, for simplicity we initially suppose that the two groups as identical in their characteristics. We later allow for asymmetry when considering one of the groups to have attributes that provide it with the advantage that a government might have.

Each group \( i=A,B \) can produce arms in period \( t \), denoted \( g_{it} \), at constant marginal cost. Furthermore, we assume that the payoffs under War and Peace are different for both sides, reflected by the superscripts \( w \) and \( p \). The main differences are that under War, there is destruction, \((1-\varphi)\), of a fraction of the rents and the winner gains an advantage in future interactions. For simplicity, we suppose that the winner of conflict receives the rent in all future periods, whereas the loser does not receive anything (for a relaxation of this assumption, see McBride and Skaperdas, 2007). Under both War and Peace a fraction of the rents are protected for both agents by the quality of the institutions they create to regulate and enforce their powersharing agreement, reflected by a security parameter \( \sigma \in [0,1] \). We assume \( \sigma \) is fixed for now; we discuss its determinants in section 3 and allow for it to be increased via costly investments in Section 4.

Under these assumptions, the following single-period \( t \) payoffs for group \( i \) under War is

\[
U^w_{it}(g_{At},g_{Bt}) = \left[ \sigma \varphi \left( \frac{1}{2} \right) + (1 - \sigma) \left( \frac{g_{it}}{g_{At}+g_{Bt}} \right) \varphi \right] Y - g_{it},
\]

where \( \varphi < 1 \) and \( g_{it}/(g_{At}+g_{Bt}) \) represents the probability group \( i \) wins the conflict. The single-period \( t \) payoff for group \( i \) under Peace is

\[
U^p_{it}(g_{At},g_{Bt}) = \left[ \sigma \left( \frac{1}{2} \right) + (1 - \sigma) \left( \frac{g_{it}}{g_{At}+g_{Bt}} \right) \right] Y - g_{it},
\]

where \( 0 \leq \sigma \leq 1 \).

Note that the term in braces represents group \( i \)'s share of the rent. Under both War and Peace, the share each side receives depends partly on state capacity and partly on arming. The better the state capacity, the larger the share of rents that are not contestable via threats with arms. When \( \sigma \) is close to 0, arming plays the biggest role in determining the share of each group. When \( \sigma \) is close to 1, arming plays very little role in the share of each side. The (1/2) share of \( Y \) indicates that the adversaries equally split the rents that are protected by state capacity. That the contestable portion of group \( i \)'s rents depends on how well it would do in a conflict captures how the bargaining outcome under the threat of conflict will depend on the relative strength of each group as measured by arms.\(^\text{245}\) Another equivalent interpretation is that each adversary has an

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\(^{245}\) Anbarci et. al. (2002) show how different bargaining solutions can induce different levels of arming in equilibrium when the utility possibilities frontier is strictly convex. Dinopoulos and Syropoulos (1998) employ the same functional form for the distribution of a prize in the case of rents from intellectual property rights, with greater protection of such rights inducing a higher \( \sigma \).
endowment of $\sigma Y/2$ that is protected from capture under both War and Settlement, although some of it is destroyed under War.\footnote{North, Wallis, and Weingast (2009, Chapter 3) describe how gradually losers of wars and political battles in England went from first losing their heads, then losing their titles and lands, to finally just losing their influence or seats in parliament. That is, there appears to be a strong relationship between greater institutional development and fewer losses of the losers of civil wars and political battles, just as higher $\sigma$ reduces the losses of the losers.}

We note that it is typical for peace agreements to have the parties to the agreement maintain their military capacity, either informally -- through militias and other forms of military readiness -- or formally as part of the agreement (Sri Lanka). Lebanon, for example, has had quotas for its different confessional groups in the military as well as for its political and administrative offices. In addition to any formal agreements that involve explicit quotas in national armies, different political parties, and administrative or electoral offices, ethnic or religious groups need to maintain militias and keep other resources (arms caches, training grounds, readiness for mobilization and special funds dedicated to them) both as a deterrent and as a bargaining tool.\footnote{See, for example, the case studies of power-sharing agreements in Colombia and Lebanon in this volume. Research on the type of power-sharing arrangement suggests that power-sharing agreements with military and territorial agreements serve as more credible signals and are more successful in keeping the peace, whereas political power-sharing agreements are less costly and, therefore, less successful (Jarstad and Nilsson, 2008).}

In any period $t$, then, the two sides make the following decisions:

1. Each side chooses its arming level $g_t$,
2. Given these levels of arming, each side makes a decision whether to accept a Peace agreement or not. If both agree to Peace, then Peace occurs. If one or both choose conflict, then War occurs.

We are interested in knowing when an equilibrium with Peace exists. Specifically, we will show when the highest payoff symmetric Markov Perfect Equilibrium (MPE) with peace exists.\footnote{See Fudenberg and Tirole (1996) for a discussion of MPE. MPE are easier to solve than history dependent strategies. Additionally, our setting immediately goes to an absorbing state after conflict thus precluding history dependent punishment across time periods. The only role for history dependence is within a single round wherein an actor can condition its decision to fight on the other actor's arming level. However, the strategic relevance for such history dependence is limited. When the MPE with Peace exists, it yields the highest payoff under Peace, so history dependent strategies will not improve payoffs. When it does not exist, any change in arming relative to that arising under the MPE with war will put one party in a better position to fight, thus not averting War. Given that the payoffs under the War MPE are the best under War, again no deviations need be considered.}

Yet before turning to a Peace equilibrium, we first note that there always exists a symmetric MPE with War. Conditional on the other choosing War in step 2, a group's choice between War and Peace is irrelevant, so both choosing War can always be sustained in an MPE. There will thus be an MPE in which each chooses an arming level $g^*_W$ and War. Given War, the value function for a group is...
To find the equilibrium \( g^*_W \), we obtain the first order condition of (3) and use symmetry \( g^*_W = g_i \) to solve for \( g^*_W \):

\[
\left[\frac{1}{g_i + g^*_W} - \frac{g_i}{(g_i + g^*_W)^2}\right] (1 - \sigma) \left[ \varphi + \left( \frac{\delta}{1 - \delta} \right) \right] Y - 1 = 0 \Rightarrow \\
\left( \frac{g^*_W}{g^*_W + g^*_W} \right)^{(1 - \sigma) \left[ \varphi + \left( \frac{\delta}{1 - \delta} \right) \right]} Y = 1 \Rightarrow \\
g^*_W = \left( \frac{1}{4} \right) (1 - \sigma) \left[ \varphi + \left( \frac{\delta}{1 - \delta} \right) \right] Y
\]

Under the MPE each group chooses this \( g^*_W \) and War. Group \( i \)'s present discounted payoff in this MPE is

\[
V^W_i = \sigma \left[ \varphi + \left( \frac{\delta}{1 - \delta} \right) \right] \left( \frac{1}{2} \right) Y + \left( \frac{g^*_W}{g^*_W + g^*_W} \right) (1 - \sigma) \left[ \varphi + \left( \frac{\delta}{1 - \delta} \right) \right] Y - g^*_W = \left( \frac{1}{4} \right) (1 + \sigma) \left[ \varphi + \left( \frac{\delta}{1 - \delta} \right) \right] Y
\]  

We are interested in when an equilibrium with Peace exists. Consider a Markov strategy of this form: “In period \( t \) of a contestable state: set \( g^*_i = g^*_P \) and choose Peace.” If each group follows this strategy, then group \( i \)'s present discounted payoff is

\[
V^P_i = \left( \frac{1}{1 - \delta} \right) \sigma \left( \frac{1}{2} \right) + (1 - \sigma) \left( \frac{g^*_P}{g^*_P + g^*_P} \right) Y - \left( \frac{1}{1 - \delta} \right) g^*_P = \left( \frac{1}{4} \right) (\frac{1}{1 - \delta}) g^*_P
\]

Both groups choosing this strategy will be a MPE (hereafter, equilibrium) when neither group can make a one-shot deviation to achieve a higher payoff. There are three types of one-shot deviation to consider. The first type is to set \( g^*_i \neq g^*_P \) in step 1 and choose Peace in step 2. The second type is to set \( g^*_i = g^*_P \) but choose War in step 2. The third is to set \( g^*_i \neq g^*_P \) in step 1 and choose War in step 2.

A first type deviation will not be made if, conditional on peace, \( g^*_P \) is a Nash equilibrium of the single-period arming game. To find this \( g^*_P \), we obtain the first order condition of \( U_i^P(g^*_A, g^*_B) \),

\[
(1 - \sigma) \left[ \left( \frac{1}{g^*_A + g^*_B} \right) - \left( \frac{g^*_i}{(g^*_A + g^*_B)^2} \right) \right] Y - 1 = 0 \Rightarrow \\
(1 - \sigma) \left( \frac{g^*_i}{(g^*_A + g^*_B)^2} \right) Y = 1
\]

and use symmetry \( g^*_i = g^*_j = g^*_P \) to obtain

\[
g^*_P = \left( \frac{1}{4} \right) (1 - \sigma) Y.
\]

With this \( g^*_P \) arming level, no second type deviations will be made. From now on, we assume this \( g^*_P \) so that equation (5) becomes

\[
V^P_i = \left( \frac{1}{4} \right) \sigma \left( \frac{1}{2} \right) + (1 - \sigma) \left( \frac{g^*_P}{g^*_P + g^*_P} \right) Y - \left( \frac{1}{4} \right) (\frac{1}{1 - \delta}) g^*_P
\]
\[ V_i^P = \left( \frac{1}{1-\delta} \right) \left( \frac{1}{4} \right) (1 + \sigma)Y. \]

A second type deviation will not be made in step 2 if the payoff of choosing Peace exceeds that of choosing War condition on both having chosen \( g_P^* \) in step 1:

\[
\left( \frac{1}{2} \right) Y + \delta V_i^P \geq \left( \frac{1}{2} \right) \left[ \varphi + \left( \frac{\delta}{1-\delta} \right) \right] Y \Rightarrow \\
\sigma \geq 1 - \left( \frac{2(1-\varphi)(1-\delta)}{\delta} \right) \equiv \sigma^* \\
(6)
\]

This value \( \sigma^* \) is the minimum level of state capacity required to prevent a second type deviation. Observe that this is more likely to be met when conflict is destructive (\( \varphi \) low) and the future is heavily discounted (\( \delta \) low). (Note also that for \( \sigma^* \) to be positive, \( \delta \) needs to be larger than \( \frac{2-2\varphi}{3-2\varphi} \), but even if \( \sigma^* \) were negative (6) would be satisfied.)

A third type deviation will not be made in steps 1 and 2 when \( V_i^P \) is greater or equal to the payoff from the deviation:

\[
\left( \frac{1}{1-\delta} \right) \left( \frac{1}{4} \right) (1 + \sigma)Y \geq \sigma \left( \frac{1}{2} \right) \left( \varphi Y + \left( \frac{\delta}{1-\delta} \right) Y \right) + \max_{g'} \quad (1 - \sigma) \left( \frac{g'}{g' + g_P^*} \right) \left( \varphi + \left( \frac{\delta}{1-\delta} \right) \right) Y - g' \\
(8)
\]

The right hand side (RHS) of this inequality is the highest payoff achievable when choosing \( g' \) given \( g_P^* \) and War.

Solving for the best arming deviation \( g'^* \) yields

\[
g'^* = \sqrt{(1 - \sigma) g_P^* \left( \varphi + \left( \frac{\delta}{1-\delta} \right) \right) Y - g_P^*} \\
(9)
\]

Plugging \( g'^* \) into condition (8) and some manipulation reveals that (8) is satisfied when

\[
\sigma \geq \left( \frac{4(\varphi(1-\delta)+\delta)-\sqrt{(1-\delta)\sqrt{\varphi(1-\delta)+\delta}+\delta}}{2-2(\varphi(1-\delta)+\delta)+4(\varphi(1-\delta)+\delta)-4\sqrt{(1-\delta)\sqrt{\varphi(1-\delta)+\delta}+\delta}} \right) \equiv \hat{\sigma} \\
(10)
\]

It can be shown that the denominator of \( \sigma \) is always positive although the numerator can be negative for combinations of a low \( \varphi \) and a low \( \delta \), and we have \( \hat{\sigma} < \hat{\delta} \). Moreover, if a second type deviation is profitable then there must be a profitable third type deviation, which in turn implies that for some values of \( \sigma \) there is a profitable third type deviation but not a profitable second type deviation. Thus, \( \hat{\sigma} \geq \sigma^* \).

Continuing the logic, the Peace MPE exists when \( \sigma \geq \hat{\sigma} \). When state capacity \( \sigma \) is sufficiently large, Peace is a self-enforcing arrangement between potential adversaries. Peace is costly to maintain as each side must continue to arm to maintain a bargaining position. However, with the peace arming level \( g_P^* = \left( \frac{1}{4} \right) (1 - \sigma)Y \), we observe that the higher the state capacity the
fewer the resources devoted to arming. With maximal state capacity ($\sigma = 1$), the Peace equilibrium achieves an efficient outcome with no resources spent on arming and no resources destroyed by conflict.

We note that $\sigma$ approaches 1 as the discount factor $\delta$ goes to 1. That Peace requires low discount factors runs counter to the standard Folk Theorem intuition. However, as McBride and Skaperdas (2007, 2009) explain, this counterintuitive result follows from the dynamic nature of the interaction. Because one group can eliminate its opponent through conflict, engaging in a conflict may be costly today but yield high rewards tomorrow as future resources need not be devoted to arming.

**ON THE DETERMINANTS OF COMMITMENT AND STATE CAPACITY**

We have seen the critical importance the level of the parameter $\sigma$ has in whether War or Peace prevails. Low levels of the parameter imply that the mechanisms that induce Peace are rather undeveloped and the adversaries need to keep high levels of arming in order to maintain their bargaining power. In turn, this high cost of Peace would lead to War. When the mechanisms for supporting Peace are more developed and the parties can keep lower levels of arming in order to maintain their respective bargaining positions, War is not attractive. What determines, then, the level of governance, security, property rights, or, in short, state capacity, which encourages these commitments to peace? We first briefly discuss some of the possible determinants in general, and then examine the actions that the adversaries might be able to take to improve their ability to commit.

We can conceive of $\sigma$ as a function of accumulated investments. The least that is required is the presence of channels of communication and diplomacy between the participants. For higher levels of commitment, rudimentary forms of governance become necessary: mechanisms for making collective decisions and agreements; elementary courts for the adjudication of disputes; security officers for the enforcement of decisions, court rulings, and agreements.

An example of such a rudimentary institution of governance that was agreed upon and paid for by adversaries who were seeking to minimize outright conflict among them is that of the podesta in fourteenth century Genoa (Greif, 1998). The main competing clans -- previously engaged in intermittent civil war for decades, with no clear dominant clan among them -- agreed to hire every year an outsider, the podesta, along with a limited staff and armed men, who served as administrator and law enforcer but without having enough military capacity to ally himself with one of the clans and expect to defeat the others. Thus, the clans paid for the services of the podesta to maintain a delicate balance of power. They still had to maintain some military readiness but evidently not as much as in the absence of the podesta and with lower risk of warfare.

Whereas many developing countries might still benefit from institutions like that of the podesta, any institutions that allow for greater commitment and less arming on the part of the adversaries would be useful. Predictable and institutionalized ways of law making increases the commitment power of the state that the laws will continue to hold (Keefer, 2008, North et. al., 2009). Power-sharing agreements, like those in Lebanon and Mozambique, that specify in detail how different offices in the bureaucracy and the military are to be distributed between the former adversaries may seem rigid and inefficient yet they can be successful in sustaining peace because of the degree of commitment that they create. In the case of Mozambique the military officers down to the lowest ranks are alternating between supporters of FRELIMO and RENAMO, the
two main parties representing the two sides in their civil war, an arrangement that has provided reasonable assurance and commitment to both parties that the other will not use the power of the state against the other. Moreover, although FRELIMO has been continuously in power as the government since the end of civil war (as well as before), the military itself is perceived as being a state organization that is relatively independent of the government and, thus, it could argued to have contributed to almost two decades of peace in the country.

Building professional police forces, armies, a modern bureaucracy as well as courts are all means for enforcing laws can also be considered investments that enhance state capacity. Modern, western versions of these institutions take tremendous resources and time to build and should only be built for their function and not just to mimic form embodied by the modern state. Like the podesta, local institutions, expanded to sustain peace and build credible commitments can lead to future investments and expansion of state capacity. Examples of such institutions include the Conflict Early Warning and Early Response Mechanism (CEWARN) active in pastoral areas of Ethiopia, Kenya, Uganda and Sudan, which serves as a local observer and early warning system to avoid conflict, where publicity acts as a type of enforcement. The investments by local actors, including those who have been engaged in violence in the past, are intended to reduce current expenditures on arming which can range from simply mobilizing quickly with response to a threat to actively engaging in negotiations over issues which are raised by CEWARN.250

Likewise, the Gacaca courts of Rwanda can be interpreted as a local investment in state capacity to make credible commitments in post-conflict as they provided a local means of settling grievances that was more credible than state institutions. Actors in post-conflict countries and countries at high risk of conflict that do not invest in such institutions must continue arming in order to maintain their respective bargaining positions.

EXTERMAN ACTORS AND FORCES, HISTORY AND OTHER CONSIDERATIONS

We next review the actors and forces that can determine investments in state capacity.

Outsiders

No country is an island when it comes to influences on civil wars and other domestic conflicts. Outsiders -- states, international organizations, NGOs, firms, and powerful individuals -- typically have direct economic or other interests in the country whereas larger states might have longer-term, geopolitical interests on the political and economic direction a country takes.

The post-World War II collective security arrangements tend to guarantee existing borders. While these arrangements might have reduced the number of interstate wars, the large number of civil wars indicates that collective security norms do not spill over into the domestic arena.251 With regard to improving domestic security and conflict management, outsiders can

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249 The contribution of a modern bureaucracy towards peace and prosperity is not to be overlooked. Research by Przeworski et al (2000) and Keefer (2008) demonstrate that the level of voice and accountability embodied by democratic institutions does not contribute to peace and prosperity so much as the establishment of permanent institutions and bureaucracies that reliably define the "rules of the game".

250 See examples 4 and 5 on http://www.cewarn.org/documents/success%20stories2.pdf

251 Indeed, the legacy of international borders defined by the international state system may contribute to the incidence of civil wars (see Herbst, 2000 and Spears, 2002).
be a source of both good and bad influence. They can be a source of good by providing mediation services and even by nudging the adversaries with sticks and carrots toward solutions that the sides could not come up by themselves. They can provide short-term and long-term assistance with state building, from direct budgetary help to advice on the building of bureaucracy and courts, as well as of the more conventional technical assistance in the building of infrastructure.

Outsiders can also be a negative influence when they directly intervene in conflict and even instigate conflict, wittingly or unwittingly. When outside economic interests feel threatened by a government and finance military opposition, even as a bargaining device, the level of trust and ability to commit to future agreements (that is, the level of $\sigma$) between the government and its domestic adversaries often deteriorates. Large states with long-term geopolitical interests might want to undermine stability in another large state's backyard of a satellite state and undermine domestic stability there or simply makes sure to fuel continued conflict. Even some actions of the "international community" that are professed to be acting in the interest of peace and stability could unwittingly undermine stability and peace (and arguably have in the past).

The duality of external interventions as either stabilizing or destabilizing forces is further complicated by the identification of some actors with the government. When one of the actors is the government its interventions from external actors on behalf of that actor are interpreted as "stabilizing" in one sense (reinforcing the international architecture through collective security agreements as described above), while possibly protracting a conflict that is otherwise untenable and thereby leading to "instability" in the form of protracted conflict. We explore the implications of such interventions in the final section of the paper.

Given that the world has become increasingly globalized economically since World War II, it would be difficult to conceive of internal conflicts in isolation from the rest of the world and the role that outside actors play in either alleviating or exacerbating these conflicts. Research on the effectiveness of peacekeeping on promoting the peace in post-conflict environments (Fortna, 2004, Doyle and Sambanis, 2006) and the role of third parties (Walter, 2002) provides useful insights on the role of outsiders. Still, there is much more room for investigation of the role that other external actors, neighbors, regional actors and global superpowers, play in the promotion and undermining of peace.

History

Thinking of conflict management institutions as capital inevitably brings forth the importance of what has occurred in the past between the adversaries involved in conflict and in the history of the country in general (ie. what capital has been invested in in the past and what depreciation has occurred during violence?). As a result of depreciation of social capital, very intense and long-lasting conflicts may eventually become intractable. Weak governance in the first place is

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252 Doyle and Sambanis (2006) find a positive role for UN peacekeeping operations, whereas Sambanis and Schulhofer-Wohl (2005) find evidence of a positive effect of UN peacekeeping operations but no discernible effect on non-UN operations. Walter (2002) finds a positive correlation between third-party security guarantees and power-sharing agreements, but had difficulties find evidence of causality of one way or another.

253 Prunier (2009), for example, makes a strong case that a series of actions by Western states and NGOs both prolonged the Rwandan genocide and subsequently unwittingly facilitated the intensification of the wars in the Democratic Republic of the Congo.

254 Hartzell and Hoddie (2003) find that more intense conflicts result in less sustainable peace. Cunningham (2006) finds that longer wars produce more spoilers and veto players which further perpetuate conflict.
more likely to lead to conflict (World Bank, 2011). And once conflict begins, whatever little capital of conflict management existed beforehand can quickly depreciate. Bureaucracies, courts, security agencies can deteriorate or stop functioning altogether. Even channels of communication and diplomacy may shut down. Achieving a long-lasting agreement, then, could become ever harder as conflict progresses. Political and governance traditions from the past could help to at least start negotiation. These can vary widely and can include traditional tribal practices of elder gatherings to governance practices imported from abroad.

Investments by Adversaries

In the end, given whatever capital has been left over from the past and with the help (or hindrance) of outsiders, the adversaries themselves will need to negotiate, structure an agreement, and make sure that it is long-lasting. That is, the parties themselves can be thought of as making investments in conflict management and governance. The actual choices of investment by the parties can be ordinary non-cooperative choices or closer to the socially optimal ones (which are higher than the noncooperative choices.) We next turn to a formal analysis of this problem.

ENDOGENOUS DETERMINATION OF STATE CAPACITY

As we mentioned earlier the parameter $\sigma$ can be considered a function of the total "capital", $K$, in conflict management and governance, where $\sigma(K)$ denotes the relevant function. $K$ can be broken down into two parts: $K_-$, the capital that has been inherited from the past and includes the effects of third parties; and the investments undertaken by the two parties, $I_A$ and $I_B$. Thus,

$$\sigma = \sigma(I_A + I_B + K_-)$$

In addition to $\sigma(\cdot)$ being increasing in its argument, we assume that it is strictly concave and differentiable. Furthermore, let $q$ denote the price of these investments to each party.

To keep our analysis simple and main idea clear, we here suppose that each of the two adversaries can undertake a one-time investment in state capacity capital. After they make their investments simultaneously and publicly, they then engage in the interaction studied in Section 2. That is, after making their investments, they then decide how much to arm and whether or not to engage in conflict. As before, conflict occurs if one or both choose it.

If $\sigma(K_-) \geq \delta$, then Peace can be sustained no matter the investments $I_A$ and $I_B$. The interesting case, and the case which we assume from now on, is when $\sigma(K_-) < \delta$.

We again focus on symmetric strategies both before and after investments are made. If investments raise $\sigma(I_A + I_B + K_-)$ above $\delta$, then we assume the (symmetric) Peace equilibrium is played thereafter.\(^{255}\)

If $\sigma(I_A + I_B + K_-) < \delta$, then the (symmetric) War equilibrium prevails. Thus, we need to find under what conditions the groups will choose investments that raise the total capital to a

\(^{255}\)Because both the War MPE and Peace MPE exist when the Peace MPE exists, our assumption is valid to the extent that there is a viable equilibrium selection argument that can justify selecting Peace. In our case, there is a simple selection principle of weak dominance that gives us the Peace MPE. See Baron and Kalai (1993) for a discussion.
level above the threshold \( \sigma' \). Given symmetric coordinated actions after investments, the expected payoff for group \( i \) from before investments are made is:

\[
V_i(I_A, I_B) = \begin{cases} 
\left( \frac{1}{4} \right) \left( \frac{1}{1-\delta} \right) \left( 1 + \sigma(I_A + I_B + K_-) \right) Y - q I_i & \text{if } \sigma(I_A + I_B + K_-) \geq \sigma' \\
\left( \frac{1}{4} \right) \left( 1 + \sigma(I_A + I_B + K_-) \right) \left[ \varphi + \left( \frac{\delta}{1-\delta} \right) \right] Y - q I_i & \text{if } \sigma(I_A + I_B + K_-) < \sigma'
\end{cases}
\] (11)

Notice that War payoff is increasing in \( \sigma \) as well. However, the marginal return on investing in state capacity under War \( \sigma'(I_A + I_B + K_-) \left[ \varphi + \left( \frac{\delta}{1-\delta} \right) \left( \frac{Y}{4} \right) \right] \) is lower than that under Peace \( \sigma'(I_A + I_B + K_-) \left( \frac{Y}{4(1-\delta)} \right) \). Moreover, although there might be circumstances under which adversaries might choose to invest in state capacity even when they anticipate War, such investment can be expected to be logistically more difficult to accomplish and we therefore disregard this possibility here. We therefore concentrate on cases in which if investments in state capacity cannot bring security to or above the threshold level \( \sigma^- \), no investment can be expected at all.

As before, a War equilibrium in which each selects \((I_i = 0, g^*_W, \text{War})\) always exists. The strategy of interest to us has each group select \((I^*, g^*_P, \text{Peace})\) with \( \sigma(2I^* + K_-) \geq \sigma' \). Given that the last two in this triplet have been studied above, we need only determine when the investment \( I^* \) is optimal given the opponent chooses this strategy.

There are two things to consider here: what is the \( I^* \) that maximizes the Peace payoff, and is each contributing \( I^* \) enough to bring state capacity above \( \sigma' \)? We examine each of these in turn. The first order condition of the \( V_i(I_A, I_B) \) Peace payoff with \( I_A = I_B = I^* \) identifies the best investments assuming Peace:

\[
\sigma'(2I^* + K_-) = \left( \frac{4q(1-\delta)}{Y} \right)
\] (12)

If we have

\[
\left( \frac{1}{4} \right) \left( \frac{1}{1-\delta} \right) \left( 1 + \sigma(2I^* + K_-) \right) Y - q I^* \geq \left( \frac{1}{4} \right) \left( 1 + \sigma(K_-) \right) \left[ \varphi + \left( \frac{\delta}{1-\delta} \right) \right] Y
\] (13)

then the Peace with investment equilibrium exists.

This last condition reveals that high destruction from conflict (low \( \varphi \)) makes Peace more likely. It is also worth noting the role of the function \( \sigma(\cdot) \). For investments in Peace to occur, the returns to investment must be sufficiently large. For one, the slope of the state capacity production function must be sufficiently high. In particular, if we define \( \sigma(\tilde{K}) \equiv \sigma' \) then it is necessary that

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256 We ignore here dynamic considerations that might induce each side to invest looking into building capital for the future even though they would go to War now. A model that has genuine dynamics would be required to allow for that possibility.
\[
\sigma'(\bar{K}) \geq \left( \frac{4q(1-\delta)}{Y} \right)
\]

If current investment brings the adversaries right to the threshold capital level, then the adversaries must be willing to maintain (or exceed) those investments. Intuitively, this requires the price of investment \( q \) to be sufficiently low, and as in Section 2 the discount factor must be sufficiently low. However, observe that \( Y \) must also be sufficiently large. If the rents are too low, then the prize is not worth the investment in state capacity.

We find this last result to be significant. In most models of conflict (Przeworski 2005 is a notable exception in a different setting\(^{257}\)), a higher prize implies higher arming and worse conflict. Here we also find arming to increase in the size of the prize holding all else constant, yet there are mitigating factors that may swamp out that effect. As income rises, so do the returns to Peace and the returns to investments in the institutions that foster Peace. If the technology exists to create governance institutions, then the rising returns to Peace through investing in institutions may lead adversaries to the bargaining table as \( Y \) increases.

However, there are two constraints that might well prevent the implementation of Peace. First, one problem might be the capacity to build \( I_A^* + I_B^* \), when, as we discussed earlier, modern governing institutions take many years and decades to build. Second, even if the institutions could be built at once, it is likely the fiscal capacity of the adversaries would be severely limited and they could contribute only a fraction of the equilibrium level of investment. When obstacles to reaching equilibrium investment exist, then there is space for a good-willed outsider to intervene.

Plugging in \( I^* = \left( \frac{1}{2} \right)(K^* - K_-) \) into the value function for peace yields

\[
\left( \frac{1}{4} \right) \left( \frac{1}{1-\delta} \right) (1 + \sigma(K^*))Y - q \left( \frac{1}{2} \right) K^* + q \left( \frac{1}{2} \right) K_-
\]

Although a change in \( K_- \) does not change \( K^* \), it does affect the payoffs of the two groups. Due to the substitutability between \( K_- \) and the adversaries’ investments \( I_A \) and \( I_B \), an increase in \( K_- \) increases the adversaries’ payoffs in the case of Peace because the adversaries need only invest smaller amounts to achieve Peace.

Outside forces can help or hinder Peace. By lowering \( K_- \) via actions destructive to state capacity, outside forces can transform a peaceful setting into a conflictual one. By raising \( K_- \) via actions that build local institutions directly or by providing resources conducive to the development of governance institutions, outside forces can help foster peace.

Finally, we observe that the positive externality associated with investment in state capacity will likely yield an underprovision of governance institutions. When investments for Peace work, the equilibrium will be inefficient. Welfare (in the form of the sum of payoffs) is maximized at \( (I_A, I_B) = (\bar{I}, \bar{I}) \) when it solves

\[
\max_{I_A, I_B} V_A(I_A, I_B) + V_B(I_A, I_B)
\]

\(^{257}\) Unlike our argument which is about rent sharing between symmetric parties backed by institutionalized state capacity, Przeworski (2005) explanation is based on redistribution from wealthy to poor.
In the case of Peace, total welfare equals

\[
\left(\frac{1}{2}\right)\left(\frac{1}{1-\delta}\right)(1 + \sigma(2I + K_-))Y - qI
\]

and the level of total capital \( \bar{K} = 2\bar{I} + K_- \) that would maximize is implicitly defined by\(^{258}\)

\[
\sigma'(\bar{K}) = \left(\frac{2q(1-\delta)}{\bar{K}}\right)
\]

(15)

By comparing (12) and (15) it is clear that \( \bar{I} > I^* \) and \( \bar{K} > K^* = 2I^* + K_- \), i.e., the level of security under welfare maximization would be higher than under equilibrium, the amount of arming necessary to maintain Peace would be lower and, of course, payoffs and welfare would be higher.

Obviously, because the optimal level of investment is not an equilibrium, it would be harder to implement in a conflictual environment where the elites -- typically the agents of initiatives -- are divided. Moreover, since there may be any number of challenges to implementing the equilibrium levels of investment (capacity to build, fiscal constraints), the implied optimal levels which are even higher would be very difficult to achieve.

Both the equilibrium and optimal levels of investment, however, share some similar comparative static results. Using (10) and (13), it can be demonstrated that the respective investment levels are (i) increasing in the contestable income \( Y \); (ii) increasing in the discount factor \( \delta \); and (iii) decreasing in the price of investments \( q \). This suggests that wealthier countries should enjoy higher levels of security, at least in the long run when liquidity and capacity constraints are relaxed. External intervention that can overcome these liquidity and capacity constraints may promote attainment of equilibrium levels of security. It is important to highlight the distinction here between relaxation of liquidity and capacity constraints and substituted capacity from international actors. Relaxation of liquidity and capacity constraints effectively creates the commitment space for adversaries to make their own investments in state capacity. Meanwhile, substituted capacity, as described above, can supplant and even reduce the incentives for actors to invest in their own state capacity, reducing the attainability of sustainable peaceful equilibria.

The effect of the discount factor is the same implied by a folk-theorem argument and contrary to the effect it has on arming effect that we found earlier. Therefore, the shadow of the future can have two countervailing effects. Which effect dominates on arming can be expected to depend on the particular functional form of \( \sigma(\cdot) \) and the initial parameters.

### The Government as an Advantaged Actor

As clarified in the introduction, one of the actors in a civil conflict can be (and often is) the Government, the actor currently in charge of the State. Though the Government can be one of the two actors in our analysis up to this point, the two adversaries have been considered identical with similar budgets, constraints and efficacy, fighting for control of the contested income. What changes if the Government is different? We consider two relevant adjustments to the model

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\(^{258}\) Assuming \( Y\left(\frac{\sigma'(K_-)}{2(1-\delta)}\right) - q \geq 0 \)
when considering the Government to be one of the two actors. We forgo a detailed treatment of each and instead focus on what changes, if any, occur relative to the logic of the symmetric model from Sections 2 and 4.

Asymmetric Strength

The first adjustment is that the Government has an advantage in conflict that affords it a better probability of winning a conflict. This is captured simply by adding parameter $\gamma > 1$ to the contest success function so that the Government's probability of winning a conflict (identified as player $A$ here) is

$$\frac{Y g_A}{Y g_A + g_B}$$

and the Rebels' probability of winning is

$$\frac{g_B}{Y g_A + g_B}$$

Observe that the condition $\gamma > 1$ yields the Government the probabilistic advantage in a fight. Reflecting the asymmetry in power, state capacity also guarantees the State share $\left(\frac{\gamma}{\gamma + 1}\right)$ rather than $(1/2)$ over the secure part of income.

Leaving all else unchanged, it is straightforward to show using the first order conditions for $A$ and $B$ that in the War MPE each chooses arming level $g_W^* = \left(\frac{\gamma}{(\gamma + 1)^2}\right) (1 - \sigma) (\phi + \left(\frac{\delta}{1 - \delta}\right)) Y$, and in the Peace MPE each chooses $g_P^* = \left(\frac{\gamma}{(\gamma + 1)^2}\right) (1 - \sigma) Y$. (The symmetric case with $\gamma = 1$ yields the $g_W^*$ and $g_P^*$ arming levels reported in Section 2.) Although both actors choose the same level of arming in this case, the level of arming is lower the higher is the asymmetry parameter $\gamma$. Therefore, given that the Government receives the greater share of $Y$, the Government's payoff is higher, the higher is the value of $\gamma$. Naturally, it can also be shown that the payoff to the rebels is lower, the higher is the value of $\gamma$.

Though introducing this asymmetry changes the exact conditions for Peace to exist as an equilibrium, the changes are only quantitative in nature. The primary qualitative findings of interest from Sections 2 and 4 remain: peace arises when state capacity $\sigma$ is sufficiently large, and investments to peace will occur with large income $Y$. As far as investing in state capacity is concerned, however, there is a key difference because the marginal benefit of investing in state capacity is greater for the Government than it is for the rebels. This feature typically makes the Government the sole actor to invest in equilibrium in state capacity. That is, given the asymmetry in power expressed by $\gamma$, the Government has a greater incentive to, so to speak, "tie its hands" further by investing in commitment devices, because that greater commitment brings about greater payoffs than it would bring for the rebels.

"Over-the-horizon Guarantees."
The second adjustment we consider is such that an outside party promises to intervene in support of the State in the case of conflict, as described by Collier (2007). Again, let actor $A$ be the Government, and actor $B$ be the Rebels. Over-the-horizon guarantees are captured by assuming that $g_A = g_A' + g_X$, where $g_A'$ is the amount of arms paid for by the Government, $g_X$ is the amount of arms directed to the aid of the Government by the external actor, and $g_A$ is thus the effective arming on behalf of the Government. The payoff functions are similar to before except $g_X$ is taken to be exogenous and the cost of arming is $c g_A'$. We here assume that $g_X$ is credibly promised in case of a fight, which in turn implies that the Government is assumed to have $g_A = g_A' + g_X$, effectively, when bargaining for Peace.

It is reasonable to assume that $g_X < g_W^*$ and $g_X < g_P^*$ so that the Government must undertake some level of arming itself. The marginal arming conditions for the Government are unchanged, so that $g_A$ will equal the $g_W^*$ or $g_P^*$ calculated in Section 2 depending on whether War or Peace occurs. However, the total arming paid for by the Government, $g_A'$, is less than what was paid before because $g_X$ of its arms are provided by the external actor. This lower cost implies a higher payoff for the Government under both War and Peace, and the payoff increase is much higher in case of Peace because the $g_X$ promise is in effect for all future periods and not just the period of conflict. Although this makes Peace more profitable for the State, the Rebels' War-Peace payoffs are unchanged. Finally, because both sides must agree to Peace for it to occur, the conditions for the Peace MPE holding state capacity $\sigma$ fixed are unchanged.

If all other parameters are held constant, then we see no change in incentive to invest in state capacity for the two actors. Yet, the reduced need to spend resources on arms may relax the Government's fiscal constraints thereby enabling it to increase its investment in state capacity. In this regard, an external actor's promise to support the Government in case of War can create fiscal space for investments in the state capacity and improve the conditions under which Peace attains.

CONCLUDING REMARKS

In this paper we develop a simple model of conflict, allowing actors to invest in state capacity to create a commitment environment. We first employ a model in which state capacity is given exogenously to demonstrate what conditions are necessary for war to be an equilibrium solution. The model suggests that states with low capacity where conflict is not very destructive should experience more conflict.

Our model also introduces a channel through which income reduces the likelihood of conflict, namely state capacity. This reconciles theoretical models of conflict which have suggested that when income is high, there should be more conflict as there is more to fight over to the empirical literature in which conflicts are observed with greater frequency in low-income countries. When we allow for endogenous investments in state capacity, the model demonstrates how investments for peace by both actors can make peace a stable outcome.

We have also allowed for the possibility of asymmetric power relations by explicitly modeling one actor in power as the Government and the other actor out of power, with the Government having an advantage. We do not find qualitative differences from the symmetric case, except for the greater incentive of the Government to invest in state capacity.

Here we have applied the model to post-conflict states. However, these relationships among elites or other spoilers to peace may exist in any conflictual environment, developing and developed countries alike. This model could be extended to explore exactly how actors have
invested in state capacity and avoided conflict, especially for conditions which seem otherwise ripe for civil conflict. The model could be tested empirically using measures of post-conflict institution building and post-conflict demobilization and disarmament -- ceteris paribus we would expect peace to last in environments where institutions improve and arming decreases.
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Clientelism or Empowerment? The Dilemma of State Decentralization for Securing Peace and Development

Philip Oxhorn

INTRODUCTION

For several decades now, state decentralization has been a cornerstone of an exceptionally wide range of policies promoting state reform, more effective service delivery and greater levels of democratization through increased opportunities for citizen participation. Despite their varied and sometimes contradictory policy goals, “bringing the state closer to the people” has become a new mantra for policymakers and academics alike that seems to transcend ideology and academic discipline.

Not surprisingly, the empirical evidence on the success of decentralization policies is mixed at best, with several showcase successes (e.g., participatory budgeting in Porto Alegre, Brazil) standing in sharp contrast to a myriad of far less successful experiences (Manor 1999; Oxhorn et al. 2004). In particular, rather than empower citizens, participatory institutions can have the opposite effect by reinforcing traditional clientelistic relations (Oxhorn 2011; Montambeault 2009). This empirical problem is further complicated by the fact that there is no clear consensus on how to actually measure “success” given the often competing goals behind decentralization. For example, even though Porto Alegre’s participatory budget is lauded as a success in terms of citizen participation and local government accountability, it is difficult to determine whether it is the most efficient mechanism for delivery of public goods and services. In fact, it is hard to find studies that compare the relative success of specific reforms in achieving efficiency goals with their success in terms of democratization goals. Most studies either assume that the two goals are incommensurate, or that “legitimacy” or “responsiveness” is synonymous with “efficiency.”

Despite such ambiguities, however, the level of state decentralization will have an important impact on the prospects for achieving both peace and development. This is because state decentralization is intrinsically a critical aspect of any powersharing arrangements, even if is not recognized as such. Beyond the lack of conclusive empirical evidence regarding its success and the competing goals associated with it, the fundamental ambiguity regarding state decentralization policies reflects the fact that all such policies involve important issues of distribution, both within the state and among different actors. As a result, the actual impact of decentralization policies (successful or not) will be reflected in changes in how states relate to their respective societies. This process, in turn, is a function not only of the nature of the reforms, but also the way in which different actors are able to take advantage of them to further their own interests. For these same reasons, state decentralization can be even more important in postconflict settings than in other cases. In particular, decentralization can help contribute to diffusing conflict by affecting the distribution of power resources across social classes and other groupings (horizontally), and within the state (vertically) such that prior polarizing dynamics can be attenuated. The key is the potential of decentralizing reforms to redistribute power in a democratic fashion, preventing elite capture and minimizing the ability of elites to use such resources in order to entrench clientelist networks.

The chapter is divided into four sections. The first looks at decentralization in terms of distribution, distinguishing between vertical distribution within the state and horizontal
distribution among different actors. The second then examines the impact of decentralization in terms of state-society relations, focusing on how decentralization conditions a process characterized as the social construction of citizenship. The next section then briefly contrasts two processes of decentralization in order to illustrate how different decentralization processes affect powersharing: Bolivia’s Popular Participation Law and participatory budgeting. The final section draws important lessons for designing decentralization policies in postconflict settings.

**DECENTRALIZATION AS A DISTRIBUTIVE MECHANISM**

State decentralization consists fundamentally of the transfer power by the central state to subnational levels of government (Oxhorn 2004). This can be understood as a *vertical* transfer that can be understood in terms of three broad types: deconcentration, delegation and devolution (Rondinelli 1981). All three reflect varying levels of power transferred from the center to regional and/or local authorities as a result of reforms in the central state apparatus. Deconcentration reflects the decentralization of policy administration or implementation, while policy continues to be made at the central level. Delegation includes some transfer of decision-making authority, although the central state still reserves control over key aspects of policy. Finally, devolution transfers maximum decision-making authority to subnational governments. By necessity, devolution also is assumed to include a significant level of financial autonomy, through guaranteed fiscal transfers from the central state and/or significant revenue-generating capacity at the level of the subnational governments.

This vertical transfer of power can consist of various kinds of resources. These include authority to decide policies, as well as the economic resources necessary to implement them. It can entail a redistribution of resources from better off jurisdictions within a country, as well as from richer to poorer segments of society. Conversely, decentralization can be a mechanism for preserving inequality and hierarchy. For example, the military government of Augusto Pinochet in Chile implemented extensive decentralizing reforms that transferred responsibility for implementing national policies to regional and, in particular, municipal governments. In contrast to much of the literature on decentralization which stresses the importance it can have for increasing democratic legitimacy and efficiency by bringing service delivery closer to the end-user, the overriding political goal was to fragment political power and increase state penetration of society in order to better control the opposition and prevent the emergence of another Marxist government (Oxhorn 1995b). Similarly, decentralization in Mexico in the 1990s reinforced clientelist networks at the local level, despite the introduction of new participatory mechanisms explicitly designed to allow for greater levels of democratization and accountability. This is because actual authority and the bulk of the resources associated with decentralization remained at the regional level, where the reigning Institutionalized Revolutionary Party (PRI) used them to strengthen its hold over regional governments as a bulwark against a national transition to democracy (Holzner 2010).

This underscores the continued importance of the central state in understanding how decentralization works in practice. As a vertical process of transferring power, it is important to emphasize that the nature of decentralization is conditioned by the role that the central state continues to play along with regional and local governments in an overall system of governance. Privatization—the hiving off of state services to increase competition and/or reduce the size of the state—and “decentralization by default” as a consequence of the state’s incapacity to provide basic services are not considered examples of privatization (Manor 1999; Oxhorn 2004). Such
activities are, by definition, external to the state. They are governed solely by economic criteria, even though they are likely to have important political consequences. This is particularly true for cases of conflict and postconflict, where states (at any level) are likely to lack the capacity (if not political will) to ensure that such services are supplied in as inclusive a fashion as possible. In such cases, privatization and privatization by default are only likely to advantage some groups at the expense of others, either because services are biased toward particular groups (based on race, ethnicity, religion, etc.) or social classes.

The latter point underscores how decentralization inevitably affects state-society relations, the horizontal dimension of power transfer. This is because decentralization directly determines how citizens access the state and its resources. On one extreme, privileged groups are able to take advantage of the reforms to assert their control the subnational state and its resources. This can be explicit, as it was during Chile’s military regime; or de facto as has happened in Mexico or Bolivia in the 1990s, among other cases. At the other extreme, avenues for the participation of disadvantaged groups (whether they be social classes, national ethnic minorities, etc.) can be opened up through decentralization in order to effectively redistribute political, if not economic power. The epitome of this is Porto Alegre’s participatory budgeting process.

This democratizing potential of decentralization is particularly promising for maintaining peace in postconflict societies. It can maximize powersharing at subnational levels, which can have clear benefits in terms of promoting development (Narayan-Parker 2009). At the same time, democratic decentralization can contribute to diffusing national political tensions, particularly when such tensions reflect the geographical concentration of important actors. Rather than viewed as a mechanism for social control and penetration of society by the state, as in Pinochet’s Chile, important distributional issues can be more effectively addressed at the local and regional levels as a way of avoiding national polarization. The central state continues to play a key role in provided a overarching framework for managing the diversity of localities and interests (Waltzer 1992, 1999), minimizing centrifugal tendencies rather than exacerbating them by requiring that all distributional issues be decided at the pinnacle of political power. It is also important to emphasize that democratic decentralization can be quite effective in countries where there exists only a minimal consensus within society regarding the nature of the polity to which they belong. Essentially, it suffices that segments of society recognize that they form part of a larger “public” or nation, even if it is only because societal stalemate and/or international geopolitical realities make this a second best alternative, and renounce violence in pursuing their political ends (Oxhorn 2006 and 2011). Indeed, it is the lack of a deeper consensus that makes democratic decentralization that much more important for maintaining peace and minimizing disruptive conflict.

Of course, decentralization in practice can be anything but democratic. The distribution of resources to subnational levels of government only invites clientelism and the use of those resources for personal or political gain. Even in authoritarian Chile in the 1980s, local political party elites with ties to the military regime tried to parlay their political connections into benefits for their followers. This danger can be best understood in terms of competing models of citizenship.

Decentralization and the Social Construction of Citizenship\textsuperscript{259}

\textsuperscript{259} I discuss these themes at greater length in Oxhorn 2011.
The starting point for my analysis is the concept of civil society, defined as: “the social fabric formed by a multiplicity of self-constituted territorially-and functionally-based units which peacefully coexist and collectively resist subordination to the state, at the same time that they demand inclusion into national political structures” (Oxhorn 1995a, 251-2). This definition shifts the focus away from civil society’s normative or cultural content to an emphasis on power relations within a given society. A strong civil society reflects a relative dispersion of political power throughout entire polities. This, in turn, “contributes to the advent of stable democratic regimes supported by already strong, vibrant civil societies whose component elements struggled for democracy in the first place” (Oxhorn 1995a, 253). In societies where political power is more concentrated, civil society is weaker and the prospects for long-term democratic stability correspondingly are lower. The focus on self-constituted units as the component parts of civil society highlights the importance of organization in generating political power. In particular, the capacity of subaltern groups to organize themselves autonomously is a key defining characteristic of strong civil societies capable of supporting stable democratic regimes.

The nature of state-civil society relations is reflected in a process that I will refer to as the social construction of citizenship (Oxhorn 2003 and 2011). Even though there is perhaps greater consensus today than ever before on the normative content of democratic citizenship rights, there is still no consensus for implementing many specific rights of citizenship. In most new democracies, conflicts over basic citizenship rights were central yet unresolved issues in the transition process. The failure of democratic institutions to address these shortcomings after the transition is often the principal source of their fragility. The pressures for expanding citizenship rights that emerge (or fail to emerge) from within civil society, and how those pressures are dealt with by the state, are central to understanding the impact of state decentralization on democracy and peace. Citizenship reflects which groups participate in their social construction and how. This is best understood in terms of models of citizenship.

Historically, the dominant citizenship model in developing countries has been citizenship as cooptation. It was closely associated with industrialization and urbanization, starting early in the 20th century in a number of countries. The cornerstone of citizenship as cooptation was a unique process of controlled inclusion (Oxhorn 2003 and 2011). Controlled inclusion consisted of top-down processes of political and social inclusion in which citizenship rights were segmented, partial and, ultimately, precarious. Rather than substantially alter structures of inequality, it both reflected and reinforced them. Controlled inclusion was a state project intended to mediate the threat posed by organized subordinate classes through their selective and partial incorporation, severely restricting the scope and autonomy of civil society through policies of state corporatism, clientelism and populist appeals that were made possible by the resources placed at the disposal of political elites as a by-product of rapid economic growth.

Ultimately, controlled inclusion belied the existence of strong civil societies; only select segments of society were allowed to organize and the autonomy of those organizations was seriously compromised. Important social rights of citizenship were often granted in lieu of meaningful political rights, while the authoritarian nature of the regime by definition implied minimal at best respect for basic civil rights.

Citizenship as cooptation historically has co-existed with a competing citizenship model, citizenship as agency. Citizenship as agency reflects the active role that multiple actors, particularly those representing disadvantaged groups, must play in the social construction of citizenship for democratic governance to realize its full potential for incorporation. It is
synonymous with strong civil societies in Western Europe, where advanced social welfare states can be seen as one of this model of citizenship’s principal achievements.

Today, the dichotomy of citizenship as agency and citizenship as cooptation has lost its centrality to a new model of citizenship: *citizenship as consumption*. Citizens are best understood as *consumers*, spending their votes and often limited economic resources to access what normally would be considered minimal rights of democratic citizenship. This reflects how many recent transitions to democracy represent a new alternative path in the social construction of citizenship: the provision of universal political rights in the absence of universal civil rights and declining social rights. It is a pattern of state-society relations that exacerbates historical problems of inequality and weak civil societies rather than ameliorates them.

These three models have important implications for understanding the relationship between development and democracy in postconflict countries. First, citizenship as consumption is the model that is least likely to produce either sustainable peace or development. This is because it is most likely to exacerbate the underlying conflicts that led to conflict in the first place. Second, while citizenship as cooptation may be seen as the preferable short to medium term alternative in postconflict settings given its association with controlled inclusion, the historical record strongly suggests otherwise. In Latin America, for example, controlled inclusion tended to exacerbate social tensions. The implicit, if not explicit, limits to inclusion became excessively rigid, unable to accommodate the new social pressures created by socioeconomic development or alleviate historical problems of inequality and exclusion. Democracy was viewed instrumentally, as a means to achieve some other end that would be abandoned when alternative means for achieving those ends emerged. This was true not only for the Right and the Left, but for the region’s more moderate middle classes who decisively backed often violent authoritarian regimes when they felt threatened by the rising political power of the lower classes (Garretón 1989; O’Donnell 1979). Citizenship as agency, however, has the potential to address these issues in a more fluid, less confrontational manner. Rather than ignore conflict, it can channel it into effective institutions for mediation before mounting social tensions threaten (a return to) violence. Two contrasting examples, Bolivia’s Popular Participation Law and participatory budgeting in Porto Alegre are illustrative in this regard.

**PARTICIPATORY STATE DECENTRALIZATION IN BOLIVIA AND BRAZIL**

Two of the most important experiments in participatory state decentralization are the Popular Participation Law (PPL) in Bolivia and Porto Alegre’s experiment with participatory budgeting (PB) in Brazil. While the latter was a success in terms of establishing a citizenship as agency model, the Bolivian experience has been much more problematic, at least during its first decade.

**Bolivia’s Popular Participation Law**

A radical decentralization of the Bolivian state in 1994 completely reorganized Bolivia’s political landscape was around 311 municipal governments, the majority of which were not only new, but were erected precisely in those areas where the state had been most noticeably absent. Municipal governments would now have responsibility for administering health, education and infrastructure services, among other areas of social investment. Under a new

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260 I discuss these 2 experiences at greater length in Oxhorn 2011.
261 Of the 311 municipalities recognized by the PPL, 187 were new.
revenue sharing scheme, co-participation, the state would double the percentage of its revenues that it shared with municipal governments to 20 percent. The result was a windfall for the new city governments and many of the old ones as well. For the 42 percent of Bolivians who lived in rural areas, mostly members of indigenous communities, the state had dramatically “arrived”—and with unprecedented amounts of money to be spent locally.

Each municipality would be governed by an elected city council and mayor. To ensure that the new resources would actually benefit the community, over 16,000 Territorial Base Organizations (TBO) were legally recognized by mid-1997 (Galindo Soza 1998, 241). The TBOs were considered the authentic representatives of the interests of Bolivian civil society and many were the traditional organizations through which indigenous communities had historically governed themselves. The TBOs would establish community priorities through local participatory planning exercises associated with the elaboration of an Annual Operating Program (AOP) in each municipality. The TBOs would also select members for a new institution that would represent community interests at the level of the city government: Vigilance Committees (VC). The VCs would articulate and represent community priorities in AOP processes. They would also exercise oversight on portion of municipal budgets financed through co-participation.

The PPL ultimately sought to ensure governmental accountability and transparency by creating a hybrid form of democracy, incorporating Western traditions of representative democracy with local, indigenous traditions of community self-government—“individual liberty with communitarian symbiosis” (Secretaría Nacional de Participación Popular 1997, 10). In one fell swoop, the PPL offered institutional solutions for addressing many of the problems plaguing Bolivia, from weak state to the development of a multi-ethnic society. Despite some notable local successes, the PPL failed to live up to expectations for generating citizenship as agency. Instead, it helped usher in a prolonged period of political instability. Several factors help explain this failure.

First, the PPL was conceived and designed with virtually no input from civil society (Grindle 2000). Then-President Gonzalo Sánchez de Lozado was actively involved, working closely with his key advisors. Even his Vice President at the time, Víctor Hugo Cárdenas, who was one of the most prominent political leaders of indigenous descent in Latin America, played almost no role.

Second, the decision to base PPL participation on TBOs meant that functionally based organizations were deliberately excluded. Ironically, this decision excluded the principal actor in Bolivian civil society advocating decentralization: civic committees. The rest of Bolivian civil society was relatively silent on the matter. Civic committees had become increasingly important as an alternative to Bolivia’s corrupt political party system; they were largely urban and often had close ties to business groups, which were all sources of distrust among the PPL’s architects.

Having excluded the principal groups demanding decentralization from the PPL framework, the PPL’s ultimate success was dependent on sectors of civil society that had not participated in its elaboration and that were historically suspicious of the Bolivian state. The Government had to win over public opinion once the law was already in place in the face of a very effective opposition campaign against the “damned laws” that was able to mobilize substantial support from a variety of sources, including political parties, functional organizations (especially organized labor) and non-governmental organizations. Repression of protesters further clouded the legitimacy of the PPL when it was being implemented (Van Cott 2000).
The key to successfully overcoming this problem inevitably became the availability of co-participation funds. As the intellectual author of the PPL and first National Secretary for Popular Participation, Carlos Hugo Molina, candidly explained, “the fundamental success for the consolidation of popular participation was the existence of resources. The people linked popular participation directly with resources” (personal interview, Santa Cruz, 7/15/99). Within four months of the law’s promulgation, particularly in rural areas, more resources had arrived than in the previous three years combined, and in many cases it was the first time they had received any resources from the state. Indeed, according to Molina, a central aspect of the government’s campaign to raise support for the PPL was to publicize how much money was arriving to local governments so that people would have an incentive to start exercising some control over its expenditure. Not surprisingly, one reason for the rapid legalization of so many TBOs was their desire to gain access to these resources—and in many instances it reflected the desire of political parties to get those TBOs most closely tied to them recognized so they could gain access as well (Booth et al. 1997, 23-4). This fundamental contradiction of attempting to legitimize institutional reforms embodying citizenship as agency through recourse to a model of citizenship as cooptation only served to heighten the suspicions of poor, marginalized groups that already were fearful of state efforts to equate narrow political interests with the public good.

The decision to limit PPL participation to territorial organizations also raised serious questions regarding the representation of marginal groups and their manipulation by political elites. Demographics and migration from depressed rural areas meant that many TBOs were stagnant, moribund organizations that had lost their appeal to local inhabitants (Booth et al. 1997, 76). The sudden influx of central government resources gave them new life, but local political elites and political party representatives often soon dominated them. In other cases, organizations were formed in order to channel funds, without any real connection to society. Such organizations were characterized as being “imposed, artificial” (personal interview, Ana María Lema, Santa Cruz, 7/15/99). These problems are particularly acute in urban areas (Programa de Las Naciones Unidas Para el Desarrollo (PNUD) 1998).

More generally, there was little effort to mobilize citizen participation to get people to actually involve themselves in local politics (Booth et al. 1997, 86). This was particularly true for the young (Programa de Las Naciones Unidas Para el Desarrollo (PNUD) 1998). In contrast, the most dynamic organizations were often functional organizations, particularly committees formed to secure irrigation and potable water. The reason for the dynamism of such committees is that they had something concrete to offer their members. Successful committees often did not disband once irrigation or potable water were obtained for their members, and have shown the capacity to move into other areas of activity related to community development. Women’s organizations were similarly excluded, with significant declines in female participation in municipal governance.

These problems have been compounded by the actual way in which participatory budgeting and the vigilance committees function in practice. In terms of participatory planning, “participation” by TBOs generally has been limited to setting priorities for expenditures and making demands, rather than actually participating in the planning process (Archondo 1997; Vargas R. 1998; Booth et al. 1997). This was partly due to the fact that the planning process was not designed for more active inputs from civil society. But it also reflects past patterns of a more

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262 This changed dramatically during the protests that later wracked Bolivia and ended Sánchez de Lozado’s second presidential term in 2003, underscoring the PPL’s inability to create new mechanisms for inclusion.
paternalistic (and sometimes conflictual) relationship between the state and civil society in which
civil society looked to the state to resolve its problems.

The problem of limited participation is compounded by a lack of synchronization
between the priorities established by the participatory budgeting process and actual municipal
budgets. In 2000, only 23 percent of the projects funded by municipal governments originated
through participatory budgeting processes. Yet actually making it into the city’s budget is
insufficient because budgeted programs frequently are not implemented. A study by Porcel and
Thévoz of 151 municipal governments (1998, 103-14) found only slightly more than 50 percent
of budgets were actually executed.

If TBOs are the foundation upon which the PPL rests, then the VCs are its central pillars.
Creating 311 VCs proved to be a slow process. By December 1995, only 163 had been formed,
so the Government issued a decree stating VCs had to be formed by December 31 in order to be
eligible for co-participation funds. “In 15 days all the political parties that governed
municipalities created Vigilance Committees” (Ardaya Salinas 1998, 25). Aside from raising
questions about the representativity of the VCs (Ardaya Salinas 1998), this underscores a
noticeable lack of social recognition of the role VCs potentially can play in empowering civil
society. Institutionally, they were created by the state and lacked social legitimacy. The result is
that the relationship between VCs and the communities they were supposed to represent is a
formal one: “the base makes demands, but does not support” the VCs (Maydana 2004, 204).

Not surprisingly, VCs are only rarely able to fulfill their oversight role (Maydana 2004;
Guzmán Boutier 1998; Booth et al. 1997). In a study of 11 VCs, only two were functioning, with
important qualifications in both cases. Their task is only made more difficult by the confusion
over the actual role of the VCs, particularly regarding the exercise of social control over the
expenditure of co-participation funds. Moreover, VCs depend on the municipal government for
vital information, and the local government often simply refuses to provide it. This can create a
vicious circle of distrust and conflict between municipal governments and the organizations
empowered by the PPL.

Far from creating a model of citizenship as agency, the PPL has fallen victim to many of
the worst aspects of the old model of citizenship as cooptation. In a social atmosphere already
characterized by high levels of distrust and skepticism toward the state, the continued existence
of the PPL belies a strong civil society. Instead, as the political instability of Bolivia over the
past few years dramatically demonstrates, social control and participation are increasingly
following a logic of “civil society versus the state” (Maydana 2004, 235).

Participatory Budgeting in Porto Alegre

Participatory budgeting (PB) was first initiated in 1989 in Porto Alegre, a medium-sized
(population 1.2 million) city in southern Brazil. While far less ambitious than the PPL in Bolivia,
it similarly sought to create new institutions for realizing citizenship as agency at the local level,
but with considerably greater success. Indeed, its resounding success led to the adoption of
similar programs in over 100 cities in Brazil, as well as many others throughout the world.264

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263 A subsequent reform increased this to 45 percent. See (Galindo Soza 2004, 112-3).
264 Although the challenges posed by PB in Porto Alegre were much less daunting than those posed by the PPL, it is
important to note that the PPL failed at the local level, given the central government’s ability to fiat in radical
changes. The same national level dynamics (corruption, excessive political party influence and pervasive
clientelism) also were very much a potential threat to the success of PB in Porto Alegre.
In sharp contrast to the insulated, largely secretive process through which the PPL was designed, PB in Brazil was made possible by the 1988 Constitution that was crafted with considerable input from civil society. The new constitution made PB possible by granting greater authority to local governments to design new policymaking processes and recognizing the legitimacy of participatory institutions (Wampler and Avritzer 2004). Rather than mandate a single institutional design for the entire country, Brazil’s 1988 Constitution facilitated local experimentation, and Porto Alegre took up the challenge.

Several local factors heavily influenced the direction new reforms would take in Porto Alegre. Porto Alegre had enjoyed a particularly vibrant civil society, which grew in opposition to Brazil’s military dictatorship (1964-1985). This experience was ultimately eclipsed by the 1986 electoral victory of the Democratic Labor Party (PDT), a leftwing populist party that demobilized civil society in order to re-impose a more traditional clientelistic government. The initial proposal for some form of participatory budgeting actually originated within civil society, in large part to allow civil society organizations to renew their own sagging legitimacy in the face of the pervasive clientelism of the PDT government. (Avritzer 2002; Baiocchi 2002; Wampler and Avritzer 2004).

The leftwing Worker’s Party (PT) won the 1988 municipal elections, in large part because of public repudiation of the PDT. It had yet to become established as a strong party in Porto Alegre. Despite divisions within the PT (Goldfrank 2003), the party ultimately decided to make PB the cornerstone of its municipal policies (Baiocchi 2002; Avritzer 2002). Central to this decision were the close relations between the PT and the various civil society actors demanding greater popular participation in municipal government. Indeed, this combination of party commitment and close ties to autonomous (albeit sympathetic) social movements ultimately proved key to the success of PB (Heller 2001).

Despite these favorable circumstances, PB got off to a rocky start. Participation was initially relatively low and actually declined during its first two years (Goldfrank 2003). The PT responded by working with civil society organizations, negotiating and perfecting the institutions of PB. Funding levels were actually increased along with the scope of PB, so that by the late 1990s 100 percent of all discretionary municipal expenditures were decided through PB (Wampler and Avritzer 2004, 307). Deliberate efforts were also made to encourage local participants to think beyond their immediate communities and PB effectively began to address city-wide concerns (Baiocchi 2002).

The end result of PB has been “a profound transformation of civil society itself” (Baiocchi 2002, 23). The level of public participation has continually increased, from just 976 in 1990 to 26,807 in 2000 (Wampler and Avritzer 2004, 302). In contrast to the PPL, participation is open to all. A deliberate decision was made not to base participation exclusively on prior membership in any organization, often inviting people to participate for the first time. Moreover, the number of social organizations has increased markedly as a result of the PB process. Conservative estimates suggest that the number of neighborhood organizations increased from 180 in 1986 to 540 in 1998 (Baiocchi 2002, 25). Ultimately, PB has become an example of how “civil society organizations challenge old practices, such as clientelism and patronage, while simultaneously offering concrete alternatives” (Wampler and Avritzer 2004, 291).

Most significantly, growing levels of participation and organization tend to concentrate in poorer areas, and people with lower incomes and levels of education tend to predominate in the PB process. This, plus the fact that municipal expenditures have been deliberately redistributed toward poorer areas of the city, underscores the empowerment PB offers for disadvantaged
groups. More precisely, citizens can see how their collective activities contribute to policymaking in positive ways, creating a potentially virtuous cycle of growing civil society strength, dispersion of economic and political power and more inclusive democratic governance.

**TOWARD CITIZENSHIP AS AGENCY THROUGH DEMOCRATIC DECENTRALIZATION**

Not surprisingly, corruption and the capturing of the state by elite groups are closely associated with conflict (Narayan-Parker 2009). State decentralization as a process of power distribution can either exacerbate this problem in postconflict settings or contribute toward its amelioration. The experience of Participatory Budgeting in Porto Alegre suggests the direction to take. Political will, while necessary, is not sufficient for achieving citizenship as agency. This was the goal of the people who designed the PPL, but in cutting themselves off from civil society, the institutions they boldly created could not live up to their own promise. The exclusionary, top-down means they chose made it all but impossible to achieve the more inclusionary, bottom-up vision of democracy that guided their efforts. Rather than creating cumulative processes through which citizen participation and the autonomous organization of civil society would increase, the opposite took place as initial skepticism toward the state was exacerbated, both by how the PPL was implemented and by its own limits that reflected elite visions and (mis)understandings more than the needs and aspirations of Bolivian citizens.

It is also important to recognize that the contradiction at the core of the PPL ultimately proved fatal in terms of strengthening civil society and creating citizenship as agency. Overshadowing the PPL’s lofty pretensions was the inescapable presence of important elements of citizenship as cooptation in the form of co-participation revenues and the lack of any effective mechanisms for ensuring that the public good would ultimately prevail. This contrasts sharply with the experience of PB in Porto Alegre. Working with civil society, a clear and powerful alternative to citizenship as either cooptation or consumption was created, literally from the bottom-up. The interchange between the PT as a political party, civil society and the local state created a process that strengthened civil society and the quality of citizenship.

It is important not to exaggerate the success of PB in Porto Alegre. It is clearly the most successful example out of more than 100 similar experiments, in a country with over 5,000 city governments. However important it is for the citizens of Porto Alegre, PB still controls just 10-15 percent of municipal expenditures amounting to a meager per capita level of just over $200 (Wampler and Avritzer 2004, 307). While it is unquestionably an important right of citizenship for people to actually decide where a school will be built, more fundamental decisions about school staffing and curriculum, for example, are made elsewhere. The ultimate challenge is to “scale-up” PB in the determination of national policies, and/or further decentralize decision-making authority to local governments so that larger issues can be addressed.

Yet the insights Porto Alegre offers have important implications for sustaining peace and development in postconflict settings. Rather than centralize power or distribute it in ways that may exacerbate societal inequalities that led to conflict in the first instance, the localization of decision-making can help achieve at least local consensus and thereby help diffuse national polarizing dynamics. However important PP was in Porto Alegre, in many ways the process it embodies of civil society working with the state is even a greater imperative for postconflict settings where problems of legitimacy and social exclusion are often much more significant. In
other words, the very immensity of the challenge of achieving both peace and development are the best justification of democratic decentralization policies in postconflict settings.
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Producing Peace in Post-Conflict Countries

Jean-Paul Azam

INTRODUCTION

The key challenge in post-conflict countries is to avoid restoring the pre-conflict situation that led to the outbreak of violence in the first place. There are lots of examples in the past where the international community mistakenly took a temporary respite of violence as the beginning of a new era of peaceful development, without paying due attention to the fundamental determinants of the underlying conflict. During its long civil war, for instance, Ethiopia witnessed many such examples, which are described among others in Alex de Waal’s 1991 book (Africa Watch, 1991). Then, various infrastructure projects were rebuilt time and again with aid money, just to be blown up again by the guerrilla during the next round of fighting. Successful reconstruction is thus resting on a conscious conflict-prevention strategy, which involves some public expenditure whose benefit cannot be measured by standard investment appraisal techniques. Peace is the key public good that a government must provide for economic development to take place. Without a credible perspective of lasting peace, there is no policy framework that can convince investors to bet on a country’s future development by investing in productive and largely irreversible projects. The latter would be seriously at risk if the conflict happened to resume. A reflection of this dead-end is provided by the well-known fact that civil wars mainly occur in developing countries. Rich countries are those whose political and institutional development has reached a point where civil war can be discarded as a major risk by investors.

The theory of conflict-prevention has brought out the main inputs that must be provided by a peace-minded government. Azam (1995) describes how some redistribution of the resources controlled by the government must in general be combined with military expenditures for buying peace. That paper is motivated by reference to various African countries, including some post-conflict ones like Ethiopia and Uganda in the 1990s, and some others that had not experienced such conflicts at the time, like Ivory Coast and Senegal. A suggestive econometric analysis by Azam et al. (1996) seems to confirm this theoretical prediction, by showing how public expenditures with a highly redistributive content, like health and education, reduce significantly the occurrence of political violence. The relevance of that framework for fiscal policy in post-conflict countries is highlighted by the following quote, from the first few lines of the former paper:

The outbreak of a civil war is the worst failure of a peace-keeping policy, or the dreadful result of the lack of it. Most countries in the world are made of a heterogeneous population, divided by ethnicity, religion, language, ideology, etc. It generally takes some conscious effort by the government for a state of peace to be maintained, with some clear impact on public finances (Azam, 1995, p.173).

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However, the success of such a policy is shown in that paper to rest entirely on the ability of the government to commit credibly to such a course of action, i.e., to act as a “Stackelberg leader” in game-theoretic terms. Furthermore, that paper shows that this condition is also required for foreign aid to be used in a social-welfare-enhancing way, rather than for increasing military expenditures. A related point about the link between commitment and peace was made independently by Fearon (1995) in a working paper applied to the war in Croatia in 1991-92. This point is further developed in Azam (2001) which provides a discussion of the various means used by African governments for making their promises credible. Broadly speaking, they can be grouped in two categories. The first one is comprised of the institutional solutions that can be used by the government for “tying its own hands,” by creating various kinds of “checks and balances,” including the so-called “agencies of restraint.” In many developing countries such checks and balances have been created by power-sharing arrangements. The case studies in the present volume provide various examples of this system, ranging from the very formalized one in Colombia to the much more informal one in Mozambique, with various degree of success. This line of argument thus shows how political and institutional development must go hand-in-hand with economic development. As emphasized by North (1990), the key point in institutional development is the provision of commitment devices that help making property rights and human security credible. The second one refers to the build-up by the ruler of a credible reputation of faithfulness, based on a rigorous track record of keeping promises. The drawback of this second solution is that this kind of personalized political asset is liable to disappear when the ruler dies. The example of Ivory Coast is illuminating in this respect, where the political capital accumulated by President Houphouet-Boigny during his long stay in power got rapidly eroded after his death by his chosen successor, Henri Konan-Bédié. Hence, the institutional framework is the key ingredient for establishing credibility in the long run, while the ruler’s reputation cannot outlast the latter’s lifetime. Moreover, institutions cannot be built in a vacuum, and recent empirical results suggest that a country’s natural endowment is a key determinant of its ability to develop the appropriate institutional framework for making the government’s promises credible. Fearon (2005) thus shows empirically that oil exporters are facing special challenges that undermine their government’s credibility and tend to make the occurrence of civil war more probable in this case. Azam (2009) offers an interpretation of this phenomenon, based on an analytic narrative of the oil-related conflict in Nigeria. That paper describes the dynamics of violence in Nigeria, and shows how institutional weaknesses, like the governments’ corruption at both the national and the local level, eventually made the current low-intensity conflict a cheaper solution than the previous strategy of indiscriminate violence against civilians.

The present paper provides a simple theoretical framework for discussing these issues. In the next section, it emphasizes how the government must balance its expenditures in order to produce the right mix of redistribution and deterrence for establishing a lasting and credible peaceful equilibrium. The key contribution of this theoretical exercise is presented in section 3, which brings out that high enough levels of administrative and military efficiency are required for making peace credible. Without them, the government’s political will to invest in peace would falter, opening the door to violent conflict. Hence, this model provides a theoretical underpinning for the recent emphasis put by the Bretton Woods institutions on institutional reconstruction in post-conflict countries. For example, a joint IMF-World Bank document claimed that their goal was to assist in rebuilding “the administrative and institutional capacity required to put a comprehensive economic program in place” (IMF and World Bank, 2001, pp.
The model below shows additionally that this institutional effort can usefully be complemented with a similar effort invested in the enhancement of military capacity, as a combination of the two is shown to minimize the cost of buying the peace. The issue of “armed peace” is also discussed there, i.e., the fact that it is sometimes advisable not to disarm the defeated side, but to incorporate some of its army in the national one, without dismantling its ability to resume fighting in case of need. The key point in this strategy is to enhance the government’s credibility, by reducing the administrative cost of peace. The model brings out the tradeoff that this strategy exploits between increasing the credibility of redistributive policies and reducing deterrence.

THE OPTIMAL POLICY-MIX FOR CONFLICT PREVENTION

Let us take a very simple model to capture the stakes of conflict prevention. Two players 1 and 2 are trying to share a prize worth \( P \). If they choose to fight for it, they incur a cost \( c_1 \) and \( c_2 \), respectively, which gives them a probability \( \pi \) and \( 1 - \pi \), respectively, to get \( P \). Their expected gains are then:

\[
B_1 = \pi P - c_1, \quad (1)
\]

and:

\[
B_2 = (1-\pi)P - c_2. \quad (2)
\]

Assume \( B_1 \geq 0 \) and \( B_2 \geq 0 \). Each player can choose to leave the prize to the other one without fighting, and there would thus be no point in allowing for negative values of \( B_1 \) or \( B_2 \). Then, the Utilitarian social cost of the conflict may be written as:

\[
P - (B_1 + B_2) = c_1 + c_2 > 0. \quad (3)
\]

The Required Inputs for Producing Peace

Denote \( U_1 \) and \( U_2 \) the two players’ payoffs in case of peace. Then there always exist peaceful allocations that are Pareto-preferred to fighting, and such that:

\[
U_1 + U_2 = P, \text{ with } U_1 \geq B_1 \text{ and } U_2 \geq B_2. \quad (4)
\]

The key question in conflict theory is thus why these socially preferable outcomes are not necessarily implemented. A simple answer can be found in a Coasian framework by pointing to a plausible reason why the two players’ property rights are incomplete or ill defined. This is what the theoretical literature on the failure of conflict prevention has done, by bringing out two main causes of open conflict. The inability to commit credibly to give to day part of one’s wealth at a future date is an important conflict-conducive limitation on property rights, which Azam (1995) and Fearon (1995) have brought out independently. Similarly, asymmetric information is a restriction that prevents the players from conditioning a transfer on some unobservable event without incurring some additional cost. Azam and Mesnard (2003) discuss how these two problems can trigger an open conflict, and provide some solutions for overcoming them. In the following, we develop below a third potential explanation, aimed at capturing how weak

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266 Contract theory is precisely aimed at analyzing the least-cost way of getting the required information revealed, by trading off rent-extraction with some loss of efficiency (see Salanić, 1997).
institutions may entail some transactions costs that may make conflict prevention too expensive for the government, and might thus trigger an open conflict.

For the sake of simplicity, assume that the endowment \( P \) entirely belongs initially to player 1 but with a fairly weak property right such that the other player can take it over with probability \( 1 - \pi \) by triggering the conflict. Player 1 may use two instruments for preventing this. First she can give a share \( g \) of her endowment to the other player. This way of “paying for the peace” has been widely discussed in the literature since Azam (1995), and the main problem raised in this case is how to make the following promise: “I will give you \( g \) if you don’t get armed and attack me” credible. The problem raised is that \textit{ex post}, if the second player is not threatening anymore, player 1 has not much incentive to keep her promise. This is a classic example of the time-consistency problem. Within a repeated-game framework, Acemoglu and Robinson (2006) base their theory of the economic origins of dictatorship and democracy on this question. Democracy is then viewed as a method for making the promise made by the rich to redistribute some wealth to the poor credible by giving the latter universal franchise, given that there are more of them. Majority rule gives them the power to tax the rich, and hence to manage redistribution in their favor. This solution is not necessarily workable in developing countries, where ethnic or religious divisions are in some cases more salient than income inequality. Then, majority rule might result in the unfettered domination by one ethnic group, whose promises to the minority groups might lose any kind of credibility. This point is nicely made by Fearon (1998). This issue is further discussed below, while the present theoretical exercise puts the emphasis on another kind of institutional problem. Hence, we assume for the sake of the argument that player 1 can credibly promise to give \( g \) to player 2. Azam and Mesnard (2003) use a more flexible specification, by assuming an imperfect ability to commit, such that the leading player’s promise is kept with a given probability. Acemoglu and Robinson (2006) show how such a specification can be derived from an infinite-horizon repeated game. Here, we focus instead on institutional inefficiency as a potential cause of open conflict.

The second tool that player 1 can use for preventing the conflict is deterrence. Assume that she can invest irreversibly an amount \( a \) for increasing the cost that player 2 would face were she to choose to get armed and fight. This hypothetical cost of conflict is modeled as:

\[
c_2 = \theta f(a), \quad f(0) > 0, \quad f'(a) > 0, \quad f''(a) < 0.
\]

Hence, \( a \) may capture some investment in weaponry that would make fighting more dangerous for player 2, or any other means of deterring rebellion. For example, Azam and Hoeffler (2002) show how the incumbent government can terrorize the civilian population in order to push it to flee and thus to reduce the capacity of potential rebels to find any support in its midst. They show how a “pure terror equilibrium” can exist in their model, where violence against civilians is sufficient for deterring potential rebels from taking up arms. This idea is applied in Azam (2009) for explaining the indiscriminate violence that was inflicted on civilians in the Niger Delta states of Nigeria during the military regime. The \( \theta \) parameter captures player 1’s efficiency at deterrence, i.e. her military power. We assume decreasing returns in deterrence, captured here by the concavity of the \( f(a) \) function. We further assume for the sake of simplicity that player 1 has no incentive to use these weapons \textit{ex post} for attacking player 2 if the latter is not armed. This might be the case, for example, if player 2 was in a position to consume instantly the whole of her share of the cake were player 1 to launch an attack \textit{ex post}. The latter would thus fail to catch anything valuable. Azam and Saadi-Sedik (2004) offer a deeper discussion of such an issue, in a model where the self-enforcing threat of sanctions only leads to
their implementation in case of challenge, for endogenous reasons. This issue is neglected here, for the sake of simplicity.

Furthermore, we assume that player 1 is facing some transaction costs for collecting these sums $g$ and $a$, similar to the “social cost of public funds” that plays a key part in the modern theory of economic policy (e.g., Laffont and Tirole, 1993). This might capture some transport costs for bringing $g$ to player 2, or a payment to a third party in charge of making the promise to pay this sum credible in case of peace, e.g., a Weberian bureaucracy bent on applying “rational-legal” rules, made credible by their rigidity. Similarly, there might be some transaction costs for investing $a$ in deterrence. There might be some cost for creating the buildings where the weapons are kept, or for advertising credibly their quantity. In the real world, it is not always easy to disentangle deterrence and redistribution expenditures. For example, Howe (2001) shows how armament contracts are often used in Africa for hidden redistribution purposes, e.g., when high-ranking generals purchase some out-of-order military equipment for maximizing kickbacks, in Nigeria in particular. Governments then turn a blind eye on such transactions, for the sake of buying off these officers, while potential rebels might believe that these military equipments might be suitable for defense purposes.

**The Optimal Policy-Mix for Conflict Prevention**

For the sake of simplicity, we assume that these two kinds of expenditures imply the same unit transaction cost $\gamma$. If player 1 is understood as the government and player 2 as a potential rebel, then $\gamma$ measures institutional inefficiency, i.e., the fraction of budgetary resources that is lost between their collection and the actual expenditures. This might describe the running cost of public administration, the result of corruption, or the social costs of inefficient taxation, etc. The part played by such a “melting ice” assumption as an obstacle to peace is discussed in Azam (2006), using a fairly different model. Under these assumptions, player 1 would solve the following problem, were she to choose peace:

$$U_1^* = \max_{\ g, a} \ P - (1 + \gamma)(g + a),$$

subject to player 2’s participation constraint, for convincing the latter not to choose war:

$$U_2 = g \geq B_2 = (1 - \pi)P - \theta f(a),$$

player 1’s budget constraint, beyond which player 1 cannot make any credible promise:

$$P \geq (1 + \gamma)(g + a),$$

and player 1’s own participation constraint:

$$U_1^* \geq B_1.$$  \hspace{1cm} (9)

Combining (8) and (9) shows that the budget constraint cannot be the binding one that prevents player 1 from choosing peace, because in this case:

$$U_1^* \geq B_1 \geq 0.$$  \hspace{1cm} (10)

Therefore, the steps to follow are first to find $U_1^*$ subject to (6) and (7), and then to check whether or not (9) holds too. Player 1 has no reason to leave any positive rent to player 2, so that the latter’s participation constraint (7) will be binding. Then, writing the latter as a binding equality allows us to establish proposition 1:

**Proposition 1**: The level of deterrence expenditure $a^*$ chosen by player 1 is strictly positive if the following inequality holds:
\[ \theta f'(0) > 1. \]  \hspace{1cm} (11)

**Proof:** Substitute constraint (7) into the objective function (6). Then player 1’s problem boils down to:

\[ \min_a (1 + \gamma)(1 - \pi) P - \theta f(a) + a. \] \hspace{1cm} (12)

The first-order condition for an interior solution is thus:

\[ \theta f'(a^*) = 1. \] \hspace{1cm} (13)

The second-order condition requires that \( f'(a) \) be concave, so that \( f'(a^*) < f'(0) \) if \( a^* > 0 \). If the interior solution does not exist, with \( \theta f'(a) > 1, \forall a \geq 0 \), then player 1 chooses \( a^* = f^{-1}((1 - \pi) P / \theta) > 0 \). **QED**

Figure 1 illustrates the combination of redistribution and deterrence expenditures chosen by player 1 for minimizing her private cost of maintaining peace. For constructing this diagram, we define:

\[ g(a^*) = (1 - \pi) P - \theta f(a^*) \] and \[ g(0) = (1 - \pi) P - \theta f(0). \] \hspace{1cm} (14)

**Figure 1: The Choice of Redistribution and Deterrence**

Figure 1 clearly shows why deterrence is chosen by player 1 when \( \theta f'(0) > 1 \), as we have in this case \( g(a^*) + a^* < g(0) \). Hence, the sum of her optimal redistribution and deterrence expenditures is lower than the redistribution expenditures required for maintaining peace without any deterrence. If we interpret player 1 as being the government, then the policy-mix described at figure 1 is the one that minimizes the use of public funds for buying the peace. This entails that this is the policy-mix that maximizes the amount of public resources left for
other use, e.g., for productive investment if that government has true developmental objectives. However, we show now that it does not minimize the social cost of peace, understood in a broader sense.

The Social Cost of Peace

Peace in this model is socially costly in two different ways. First, one can show easily that it is not Pareto-preferred to war. This can be seen by remarking that the difference $g(0) - g^*(a^*)$ is equivalent to a tax levied under threat by player 1 on player 2. The level $g(0)$ of the transfer is equal to the expected gain that player 2 would get in case of war, if player 1 was not investing any resource in deterrence, while $g(a^*)$ is her gain in case of peace, given the level of deterrence expenditures invested by player 1. Therefore, peace entails a net gain for player 1, otherwise she would choose war and give up deterrence, while it entails a net loss for player 2 worth $g(0) - g^*(a^*)$. Hence, peace is not Pareto-preferred to war, ex ante, as soon as there is a strictly positive level of deterrence expenditures. In other words, peace is imposed by player 1. The latter proposition may be viewed as a simple variant of Hobbes’ theory of the Leviathan (Hobbes, 1651). However, the present model adds the redistribution dimension, which mitigates the seemingly illiberal overtone of that result.

On the other hand, conflict prevention maximizes ex post social welfare if one chooses the Rawlsian maximin as a social-choice criterion. This is because war implies that either one or the other player will loose everything with some probability, whereas peace guarantees a positive gain to each one of them. More generally, conflict prevention could be justified using a theory of social aversion to private risk, as in Kolm (1998), provided the degree of social rick aversion was strong enough. Therefore, deterrence works in this model like a system of compulsory insurance, which prevents the players from loosing everything on a bet. Hence, this model shows that one can justify a pacifist position as an application of Rawls’ (1971) liberal theory of justice, as it implies that each player would be better off in case of peace than in the worst case, were she to loose the war. Investing in peace may then be described as a kind of “safety first” approach to social risk management. Similarly, one can see this position as an application of Sen’s idea of “the impossibility of a Pareian liberal” (Sen, 1970), which implies that some values must prevail in some cases over Paretian efficiency. The views of the classical liberals on this subject can be summarized by the following quote from Paine (1791): “Government […] promotes peace, as the true means of enriching a nation” (cited by Howard, 2008, p. 20).

Furthermore, one can also show that peace is socially costly in Utilitarian terms. Given the constraints presented above, and that player 1 has no reasons to leave any positive rent to player 2, so that $U_2 = B_2$, we can define the Utilitarian social cost of peace as:

$$ P - (U_1^* + U_2) = \gamma g + (1 + \gamma) a. $$

Therefore, in this model, peace is not a gift from heaven, and must be produced by investing some resources in conflict prevention. Notice that the social unit cost of redistribution is generically lower than the cost of deterrence. Therefore, the Utilitarian social cost of peace would be minimized if the latter was purchased exclusively by a transfer, without any deterrence.

Sen writes in the conclusion of that article: “…if someone does have certain liberal values, then he may have to eschew his adherence to Pareto optimality” (p.132 in Hahn and Hollis, 1979).
expenditures. Hence, player 1’s privately optimal choice does not minimize the Utilitarian social cost of peace, which would require bringing the level of deterrence to zero. Moreover, one can easily check that $a^*$ is an increasing function of $\theta$, in the interior solution, so that player 1 will spend more on it, the more effective it is at increasing player 2’s hypothetical cost of conflict. In other words, the Utilitarian social cost of deterrence increases with its effectiveness. This prediction is not valid anymore in a corner solution, when player 1 only uses deterrence for buying the peace.

**CONFLICT PREVENTION FACED WITH TRANSACTION COSTS**

Proposition 1 and figure 1 describe the peaceful equilibrium, if the latter happens to be chosen by player 1. What remains to be determined is the condition under which the latter will make this choice, i.e., to find the parameters that ensure that (9) holds.

**Peace and Government Efficiency**

The model presented above allows us to bring out how the institutional inefficiency captured by $\gamma$ can reach such a level that the peace becomes too expensive to keep for player 1. This is expressed in proposition 2:

**Proposition 2:** Peace will not be kept by player 1 if:

$$\gamma > \frac{c_i + \theta f(a^*) - a^*}{(1-\pi)P - \left(\theta f(a^*) - a^*\right)}.$$  \hspace{1cm} (16)

**Proof:** We can write:

$$U_i^* = \pi P - \gamma (1-\pi)P + (1+\gamma)\left(\theta f(a^*) - a^*\right).$$ \hspace{1cm} (17)

and thus, $U_i^* < B_i$ if inequality (16) holds. **QED**

Proposition 2 shows that the minimum level of institutional efficiency required for player 1 to choose peace is higher, (i) the higher is the required transfer for buying off player 2 and convince her not to go for the war, with high values of $(1-\pi)P$ and low values of $\theta$, and (ii) the lower is the direct cost of war, with low values of $c_i$. Notice as well that proposition 2 brings out the social gain produced by deterrence, *ceteris paribus*, despite its cost described above.

Given $\gamma$, peace is generically chosen by player 1 if $\theta$ is high enough. In that case, deterrence is effective enough for compensating the transaction cost entailed by this investment. Figure 2 enables us to see this result better. The upward sloping curve in the $\{\gamma, \theta\}$ space represents the locus of the parameter values such that (16) holds with equality. All the points located above this locus have a too high level of institutional inefficiency for peace to be chosen by player 1, while all the points located to the right show a high enough level of efficiency at deterrence for compensating the transaction costs and making peace attractive for her. Figure 2 depicts the case where $c_i > a^*$, but the opposite case would be equally acceptable too.

**Figure 2: The Choice between War and Peace**
Let us emphasize a property that the present model shares with most conflict models of this kind. The choice between war and peace here belongs to player 1, i.e., the “Stackelberg leader”. In most applications of this kind of models, this will represent the government. Hence, this property of most conflict models is in direct opposition to the widespread view that the cause of civil wars is the presence of rebels. This is tautological, as the proposition can be as convincingly reversed, as the cause of the rebels’ presence can be said to be the civil war. In fact, the responsibility for the conflict always rests on the government in this kind of models. Rocco and Ballo (2008) have developed this point for making it a theory of provocation, with an application to the recent civil war in Côte d’Ivoire. They show how the government can trigger the uprising by choosing a policy that violates the potential rebels’ participation constraint. This theoretical insight meets a common sense idea that “Political will” is a fundamental precondition for peace (Colletta et al., 1996, p.6), which basically means that no government can ever be coerced into choosing peace. The additional contribution of conflict-theory is to show that such political will is itself endogenous, depending on some deeper parameters. Figure 2 helps us to understand how such a political will can be brought about, by improving simultaneously institutional and military efficiency.

The Scope for Peace-Inducing Foreign Aid

Proposition 2, represented at figure 2, also shows that war is in this model the result of a dual inefficiency of the government. As mentioned above, even a high level of administrative inefficiency, implying a high transaction cost, could be consistent with peace if the level of military efficiency was high enough. However, peace is also consistent with other combinations of efficiency levels. Even with a low level of military efficiency, i.e., with a low value of $\theta$, player 1 might very well choose peace if her level of administrative efficiency was sufficiently high, with a low value of $\gamma$. This analysis clearly suggests that increasing the efficiency of public funds management for public administration and deterrence is more important than trying to increase the size of the pie over which people have conflicting claims. Based on survey data
on Uganda, a typical post-conflict African country, Reinikka and Svensson (2004) have shown how to increase the share of the public money reaching its target in education, one of the most redistributive type of public expenditure. Their results show that disclosing the information about these flows more transparently can help significantly to mobilize the parents for exercising an effective pressure on this sector’s public administration. This provides a very cheap way of enhancing administrative capacity, which seems especially appropriate at the local level. More generally, all kinds of policies aimed at improving public service delivery to the population may also be understood as a way of reducing $\gamma$, and thus as a means to strengthen the government’s political will to build peace.

Hence, this diagram illustrates vividly how the donor community can help the post-conflict country to create a peaceful environment for attracting investors and boosting growth. The importance of supporting the reconstruction of government institutions and of the rule of law has been recognized by the World Bank for a long time (e.g., World Bank, 1998). The additional insight brought out by the foregoing theoretical analysis is that the peace can be bought more efficiently by combining this institutional reconstruction with a concurrent effort at improving the government’s military capabilities. The aim is to move south-easterly in that space, as illustrated on figure 2 by the thick arrow, by reducing institutional inefficiency and increasing simultaneously the level of effective deterrence. The upward slope of the cut-off locus means that a peace-minded intervention involves some complementarity, such that the effort needed on either front is less demanding, the higher is the effort made on the other front. The type of support that can be given to help a post-conflict government increase the professionalism of its armed forces is illustrated by the ACRI (African Crisis Response Initiative) program launched by the U.S. government in Africa (Bierman, 1999). The latter involved the training and reinforcement of the armed forces of various African countries selected according to their commitment to some democratic values. Howe (2001) provides a thorough discussion of its achievements and its limitations. Another example is given by the British intervention in Sierra Leone, which resulted in the retraining of 8,500 troops. The latter rather effective program is criticized by Paris (2004) precisely for its narrow focus: “What the peacebuilders did, in effect, was to focus on one vital institution of the Sierra Leone government—the army—and make it more effective in order to deter and suppress violent challenges to the electoral process or its results” (Paris, 2004, p.223). The other institutions of the Sierra Leone government were given much less attention.

The Case for Armed Peace

Instead of just focusing on institutions, a post-conflict government may use a more directly political strategy for enhancing the credibility of its promises, based on the balance of strength. Such a strategy is well illustrated by the case of Chad, described by Azam and Djimtoingar (2008). Idriss Déby, who took over in 1990, put an end to about three decades of civil war by giving his opponents the means to strike back in case of breached promises. He first gave General Kamougué, the leader of the “Codos” rebellion in the south, the vice-presidency of the National Assembly, which is formally the second highest position in the country. To avoid making this just a symbolic gesture, he did not dismantle the whole rebel army, but amalgamated instead a good number of its units in the National army, without breaking them up. In so doing, he was in fact leaving to Kamougué the ability to resume fighting in case of disagreement. A similar strategy is described by Cadeado and Hamela (2009) in the case of Mozambique. The
benefit of such an approach is that it enhances directly the credibility of the government’s promises, by making it cheaper for the other player to punish any deviation. On the cost side, it also reduces somewhat the government’s efficiency at deterrence, by reducing the gap in military strength. The following simple extension of the model presented above helps us to understand the rationale for such a strategy.

Let \( w \) denote the quantity of weaponry left to the defeated side, and assume that this reduces the transactions costs faced by the government, as sketched above, while reducing also it efficiency at deterrence, by reducing the imbalance of forces. This is captured by assuming that \( \gamma = \gamma(w), \gamma'(w) < 0, \gamma^*(w) > 0 \) and \( \theta = \theta(w), \theta'(w) < 0, \theta^*(w) < 0 \). The assumed convexity of the transaction cost captures the idea that although keeping the potential rebels in arms enhances the government’s credibility, it cannot on its own reduce this cost to zero, as there are other administrative costs that are not directly related to this credibility problem. The assumed concavity of the military efficiency captures the idea that leaving a little weaponry to the potential rebels does not affect much the balance of forces, and has thus a small impact on deterrence, while a higher level of forces on the potential rebels’ side might have a more drastic impact.

Then, the minimum cost of peace for the government (player 1) can be written as:

\[
\xi_1 = \min_{a, w} (1 + \gamma(w))(g + a),
\]

subject to:

\[
g \geq (1 - \pi) P - \theta(w)f(a).
\]

Now, by substituting (19) into (18), we find that an increase in \( w \) will have two impacts on this cost: (i) the reduction in transaction cost will reduce \( \xi_1 \) by \( \gamma'(w)(g + a) \), while (ii) the cost of the required redistribution will increase by \( (1 + \gamma(w))f(a)\theta'(w) \). Hence, the net effect will reduce the cost of peace if:

\[
\frac{\gamma'(w)}{\theta'(w)} > \frac{(1 + \gamma(w))f(a)}{g + a},
\]

and will increase it otherwise. Figure 3 represents a plausible case, where condition (20) holds for low values of \( w \), while the net impact on \( \xi_1 \) becomes positive for larger values of \( w \). In this case, the cost-minimizing policy for producing the peace involves a positive level of weaponry left to the potential rebels \( w^* > 0 \). A similar point is made by Azam (2006) with a different model. Then, peace will be chosen by the ruler if the resulting minimum value of \( \xi_1 \) lies below the ruler’s cost of war \( \xi_w = (1 - \pi) P + c_1 \); war will break out otherwise.
Figure 3: A Case of Armed Peace

Figure 3 depicts a case where armed peace is the ruler’s optimum choice. Moreover, in this case, unarmed peace is impossible, as a choice of $w < w_L$, which could for example be imposed by some foreign power in the name of disarmament, would push the ruler to choose war rather than peace, because of excessively high administrative costs. Nevertheless, this theoretical framework does not rule out other cases, which might prevail for different parameter values. For example, the loss of deterrence efficiency might always dominate the gains in credibility in some cases, so that $\xi_P$ might be increasing in the whole space, making armed peace unprofitable.

CONCLUSION

This short chapter has provided a theoretical framework for thinking about the policy-mix required for producing peace. Two costly inputs are involved, namely redistribution and deterrence, and various transaction costs have to be added to their direct cost for determining the total cost of peace. When the latter is too high relative to the cost of war, then the ruler’s political will in favor of peace will falter, and war will break out. Various methods can be used for reducing the cost of peace, thus strengthening the ruler’s drive for peace, including power-sharing, armed peace, and the inflow of foreign aid. The theoretical framework presented here highlights that the donors should focus their attention on strengthening the political and administrative institutional framework in the recipient post-conflict country, while they should not shy away from investing in strengthening the latter’s military capability. Quite paradoxically, from a purely military standpoint, this chapter has also shown that armed peace, whereby the potential rebels are left in a position to challenge the government’s army in case of disagreement, as in Azam (2006), might make in some cases an important contribution to making peace credible.
REFERENCES


Appendix 1: Case Study Guidelines

These guidelines are intended to help the case study authors develop their papers and give the studies greater cohesion for comparative purposes. They are general and some will apply more to certain cases than others. It is also important that this be considered part of a dialogue. The overall objective is to bring different perspectives together so that we can help identify trends, best practices in genuinely multidisciplinary way that captures both Southern and Northern perspectives.

There are several important goals behind the case studies. These include:

- We ultimately hope to link the findings and hypotheses of the thematic papers to the individual cases to determine if they are relevant and if there are other factors which are left out.
  - For some case studies, the questions will be more speculative so that the issue is whether these factors are likely to influence future prospects for peace. We encourage the authors to speculate on these peace prospects in so far as this speculation is grounded on the thematic papers.
  - The timeframe for each case study will depend on the history and dynamics of the case. For this reason, it will be up to the authors to determine the most appropriate timeframe for their case.
- Understanding trade-offs and competing priorities. Do peace-building and development go together?
- Implications for foreign assistance: How should aid be allocated between peacebuilding (e.g., demobilization of combatants, reconciliation, post-conflict justice and reconstruction), and activities designed to increase development and the well-being of citizens?
- Attempting to understand the social, political and economic dimensions of conflict and post-conflict peace-building. This goes to the heart of the project’s multi-disciplinary perspective
  - While the powersharing theme is more in the area of expertise of political science and sociology, and the macroeconomic agenda is more in the area of expertise of economics, it is important that those parts of the case study reflect the unique insights of the other disciplines to capture possible trade-offs and cross-cutting issues.
  - Participatory Governance and service delivery, on the other hand, ideally needs to be understood from a perspective that combines economics and political sociology, even though the literature often compartmentalizes research in this area into one discipline or the other.
- Helping to identify best practices and policy recommendations reflecting the needs and priorities of people living in societies prone to violent conflict.
We have chosen the three issue areas of powersharing, democratization and the macroeconomic agenda\textsuperscript{268} because of their importance for understanding the relationship between peacebuilding and development. Yet the distinctions will inevitably become less sharp as the case studies are written and that is to be expected. In fact, we hope that the case studies will highlight the interrelations between the three issue-areas, as well as other cross-cutting issues. One cross-cutting issue, in particular, stands out:

- The role of outside actors, both internationally and regionally
  - How do exogenous shocks affect peace-building?
  - How relevant are regional dynamics?

**General Guidelines**

Case studies should be 60-80 pages (double-spaced) in length. The primary focus should be on the three issue areas, so limit the background discussion of each case to 3-5 pages. For references, please provide in-text citations (author, year of publication, page numbers) with a list of references cited at the end. Footnotes rather than endnotes should be used. We would like to have a general prospectus for each case study by March 1 in order to facilitate feedback from the project’s advisory committee. The draft papers should be ready no later than May 15 to allow people to read them before the workshop at the end of May.

A number of questions stem from thematic papers. At this stage, there are several issues we would like each case to address for each theme:

**Theme 1: Powersharing:**

In the post-conflict period, it is important to know who shared power, what groups they represented and the basis of representation (e.g., how were the officeholders chosen by the groups). Will powersharing arrangements provide the basis for an enduring peace, or do domestic and/or regional factors threaten to undermine them? How representative were the groups of the population as a whole, if at all. Does the population perceive that the government is representative? What veto gates did the different power-sharers control, particularly veto gates related to raising funds and spending them? Did the powersharing groups remain armed and organized, or not?

For countries not yet “post-conflict,” the questions would revolve around what groups are most influential and need to be included and why? What, if any, mechanisms for powersharing are being considered by the principal actors? What are the prospects for disarming powersharing groups? Are there particular domestic or regional factors that need to be addressed to ensure enduring peace?

For all the cases, how are all the key actors organized? If so, how—as political parties, social movements, armed groups or as small elite groups with little mass following? In particular, are politicians organized into cohesive political parties, or as parties that are simply a loose

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\textsuperscript{268} The descriptions of these themes and the rationale for organizing of our research can be found in the original proposal IDRC at the end of this document.
collection of candidates? If cohesive, what was the basis of cohesion: a programmatic stance seen by all the voters, military organization inherited from the conflict times, something else? What have been the principal consequences of this for each case?

To what extent will sustainable peace likely depend on redistributive policies? If so, what kinds of redistributive policies have been suggested and what are the prospects that they will be implemented?

Theme 2: Participatory Governance and Service Delivery:

From the perspective of international assistance: Given the experience in your case, should assistance privilege development over peacebuilding, or is not possible to draw conclusions in this regard? Was or is the donor focus on reconstruction, development or sustainable peace? Is there even a useful distinction that can be drawn between aid for reconstruction, development or sustainable peace? What are a few examples of the most prominent development projects that were or are being implemented? What reconstruction projects? What was the priority attached to service delivery? Were donor subsidies funneled through the government, through NGOs and other non-governmental providers, or did donors deliver services directly?

From the perspective of citizens: Were services a priority for citizens, or were they more concerned about other things (such as violence)? Who seemed to be delivering services: government, NGOs, donors, others? Do citizens and/or government officials perceive that donors are in the country for the long haul, or was there a high expectation that aid would drop sharply at any time? Has this perception had any discernable consequences on citizen and/or government behavior?

Have reforms intended to decentralize state decision-making, particularly in the area of service delivery, been discussed and/or implemented? Have actors taken a position in favor or against such reforms? If such reforms have been implemented or are on the agenda, do they include mechanisms for citizen participation?

Did political actors/citizens perceive a high threat of renewed violence? Why? Does the level of political capacity (understood as the ability of governing elites to elaborate and implement effective policies) affect incentives to resort to violence? Do citizens have information about government policy making and its effects on their welfare? Is there any evidence that this information improves government incentives regarding development/service delivery?

Theme 3: Macroeconomic Agenda for Peaceful Post-conflict:

What have been the broad patterns for fiscal, exchange rate and monetary policies for the time period covered in each case study? How can fiscal, monetary and exchange rate policies contribute to the credibility of peace? How do fiscal, monetary and exchange rate policies make countries more or less investor friendly? What are the most effective ways for coordinating fiscal and monetary policies? What should be the priority goal(s) of monetary policy in support of conflict resolution and peace? Are “optimal” (i.e., the policies that would be appropriate for
countries that are not experiencing conflict or in a post-conflict stage) exchange rate and monetary policies applicable to postconflict situations?

Appendix: Issue Area Descriptions from the Original IDRC Proposal

1) **Participatory Governance and Service Provision**: The available literature suggests that some form of participatory system is a prerequisite for a sustained peace; however, it is not clear that an ensuing democratic or participatory system has any advantage in the provision of public goods. Similarly, some literature suggests that while more participatory systems in socially fractionalized societies with strong identity politics may confer the legitimacy necessary for peace, such systems might sacrifice accountability if they create new opportunities for patronage and clientelism. Finally, while there is good evidence that suggests established democracies are better able to provide voice to the aggrieved, reducing the likelihood of civil conflict and securing civil peace, democratization is not a panacea against civil conflict, particularly if post-conflict elections may simply move the risk of conflict to a future date. This suggests a possible trade-off: When should efforts be made to democratize and reduce the risk of civil conflict and when should existing systems of government be maintained and even reinforced with bureaucracy to help ensure stability and efficiently provide public goods? How can participatory systems be effective as an instrument for the delivery of public goods and services specifically for post-conflict and fragile states? What are the options for public/private ownership in post-conflict reconstruction and what is the role of the international community in advising economic reforms for these types of states?

2) **Powersharing for Peacebuilding and Development**: It is vital to the peace and prosperity of states that their monopoly on violence is ensured, but this raises the danger that the power of “strong” states will be abused. To better understand these potentially countervailing effects, the study will center on how peace agreements, intervention strategies, demobilization strategies, and arrangements for post-conflict justice contribute to securing the peace and economic development. What are the trade-offs in peace and development associated with peace agreements that increase fiscal decentralization and political federalism? How can reforms of the military and security apparatus contribute to poverty reduction and when does it reduce the risk of new or resurgent conflict? What security sector reforms are possible in the post-conflict environment and are there hard limits to the extent of these reforms? In essence, does security always trump development?

3) **The Economic Agenda for Post-Conflict Reconstruction**: Previous research produced theoretical and empirical evidence that countries emerging out of conflicts experience certain structural shifts that affect aid effectiveness and fiscal policy, as well as exchange rate and monetary policy. This study will build on this research by addressing the following question: How can these disparate effects be integrated into a coherent macroeconomic policy agenda for fragile and post-conflict states, based on a thoroughly developed theoretical framework? Questions that remain include, for example: Can expansionary monetary policy be used to pump-prime development or should post-conflict inflation be avoided at any cost? When do sovereignty issues associated with national currencies become liabilities to a fragile state? If budget support and public good provision subsidize government expenditure in post-conflict states, when does international aid support coherent macroeconomic strategy and when might it threaten to undermine one?