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Fiscal resources for a post-conflict state

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1. *Introduction*

Armed conflict can have several economic consequences. At the macro level armed conflict is associated with lower growth, higher inflation, and has negative effects on tax revenues and investment. These mean macroeconomic instability (Gupta et.al., 2002). At the local level, conflicts disrupt markets and lead to displacement led surge in unemployment. Reintegrating ex-combatants and displaced persons can be a policy challenge (ILO, 2009). Conflict can also result in destruction of physical infrastructure and buildings including health institutions and schools.

In November 2020, an armed conflict broke out in the Tigray region of Ethiopia. It has since extended to neighbouring regions of Afar and Amhara encompassing significant parts of north and eastern parts of the country. Hostilities seem to have slowed down since December 2021 although the political settlement has not happened yet. The conflict has adversely affected the Ethiopian economy which was already suffering from macroeconomic imbalances with high inflation, high debt stock and severe foreign exchange shortages over the past 6 years. Since 2019, the government has embarked on a reform program with policies designed to realign the growth drivers to correct imbalances and foster sustainable growth. These reform efforts have been affected by the COVID-19 pandemic in addition to the armed conflict. These shocks are expected to have adverse effects on the reform in general but on the fiscal space in particular.

In 2020/21 budget deficits including grants for the federal government budget reached 2.7 percent of GDP which can be considered moderate and within target. However, a source of strain emanating from the conflict was a decline in external loans and grants (no grants were received during quarter 3 and 4 of 2020/21), which had been important in financing the fiscal deficit. To cover the deficit the government resorted to loans from domestic sources primarily banks, the National Bank of Ethiopia (NBE) and pension funds. In normal times, the government allocates a sizable budget for capital projects (44 percent in 2020/21) particularly for roads and the education sector. Revenues on the other hand, are dominated by indirect taxes particularly import duties and taxes which account for 32 percent of total tax revenue in 2020/21 budget. During 2020/21 tax revenue to GDP declined to 7 percent from 10.5 percent during the previous year partly due to the conflict. Similarly, the grant to GDP ratio declined from 1.2 percent in 2019/20 to 0.3 percent in 2020/21.

Given the multi-dimensional nature of the impact of the conflict, this note focuses on the potential fiscal impacts and options for expanding fiscal space in a post conflict context. The next section deals with the economic strain from conflict with particular emphasis on fiscal policy. The third section presents a synthesis of fiscal resource options in post conflict periods. The last section filters out the main take-aways relevant to the Ethiopian context.

2. *Post Conflict Fiscal Policy*

2.1 Economic Strain from Conflict

Armed conflict can have several economic consequences. Broadly, it has a negative impact on growth (Collier, 1999) and this impact is prominent in developing countries as their propensity to growth is higher compared to developed ones. These consequences can extend to non-conflict areas through trade, investment and other disruptions (Marano et. al., 2013). In addition, the economic costs also continue for a significant period of time after the conflict ends (Collier, 1999).

Cross-country studies indicate that unsurprisingly conflict has a large negative impact on GDP per capita. Novta and Pugacheva (2020) find that GDP per capita is about 28 percent lower 10 years after the onset of conflict. In addition, trade (both imports and exports) experienced a dramatic decline estimated at 58 percent and 34 percent lower 10 years after conflict onset respectively. This negative effect is confirmed by Diop et. al. (2021) as they find persistent, significant and instantaneous deviation of growth from the counterfactual in Africa. This effect is higher for countries with natural resource dependence. Conflict can also impact the financial sector by undermining confidence in formal financial institutions and weakening the banking sector (Raga et. al., 2021) and can increase the probability of banking crisis (Compaore et. al., 2020). It also affects public revenue mobilisation, disrupts supply chains and affects prices (Raga et. al., 2021). Muller (2013) further characterises the impact of conflict on the economy into three distinct features, disruption, permanence and externalities. Disruption pertains to the direct impact of conflict on the economy caused by lack of security. The effect of conflict on the economy persists even after the conflict has receded thus, indicating permanence of certain effects. Further, the effect extends geographically to non-conflict countries and areas.

There is also evidence that conflict has a significant negative impact on trade. Marano et. al. (2013) study the impact interstate and intrastate conflict on trade. They find that intrastate conflict has a stronger negative effect on trade and conflict in the exporting country has a negative effect on overall trade than in the importing country. They also find that the destructive effects of conflict go beyond the borders of the country hosting the conflict. This is further confirmed by Korovkin and Makarin (2019) who study the effects of the conflict between Russia and Ukraine on trade. Using a firm level panel, they find that areas in Ukraine with fewer ethnic Russians saw significant trade declines with Russia after the conflict. They attribute the results to boycotts of Russian products, and negative attitudes about Russia.

Conflict also has significant welfare costs for an extended period of time. Primarily the loss of income from economic decline worsen poverty or reduce consumption and general welfare of individuals (Odozi, 2019). Hess (2002) looks at the willingness-to-pay of individuals to avoid the economic costs of conflict. They find that in a country that has experienced conflict individuals are willing to pay approximately 8 percent of their level of consumption for peaceful living. Rockmore (2017) compares the effect of violence and insecurity in general on household consumption. The study suggests that in addition to direct violence, insecurity caused by violence in other areas reduces household consumption. Thus, on aggregate, welfare loss due to insecurity is larger than that caused by violence.

2.2 Fiscal Impact of Conflict

Conflict can have severe consequences on fiscal space through reduced revenue and the pressure for increased expenditure. The relationship between fiscal space and conflict can be bi-directional as conduct of fiscal policy can contribute to the onset of conflict (Aguirre, 2015, Chaudhury and Murshed, 2016). The reduction in economic activity caused by conflict leads to reduction in revenue while spending increase in defence results in compromise of other welfare enhancing projects (Gupta et. al., 2002).

Primarily conflict reduces the tax revenue performance of the state due to decline in economic activity especially if the conflict is protracted (Cevik and Ricco, 2020).

Continued conflict also depresses new investment which leads to further constrained revenue mobilisation capacity (Edeme and Nkalu, 2019). Chaudhury and Murshed (2016) find that after accounting for omitted variable bias, conflict reduces tax revenue by about 2 percent (statistically significant). They also acknowledge the possibility of reverse causality between tax revenue and conflict. Moreover, they find that more economic freedom leads to higher tax revenue. Developing countries are more vulnerable to fiscal impacts of conflict due to the low breadth and depth of economic activity. The results are less pronounced in countries with more diversified economy (Cevik and Ricco, 2020).

Gupta et. al.(2002) found that conflict leads to a higher share of defence spending away from spending in socially and economically productive sectors. Due to the reduction in revenue in times of conflict as indicated above, they find that spending on education and health is also affected. They recommend that avoiding or shortening conflict has positive consequences for the overall macroeconomic stability, FDI inflow and improved fiscal space. Cevik and Rocco (2015) also find that terrorism significantly and positively affected military spending after accounting for various factors including corruption, democracy, human capital, urbanization, trade openness and income.

3. Post Conflict Fiscal Resource Options

Experience in restoring fiscal resources in post-conflict context has been mixed. In most cases, recovery is only to close to pre-conflict levels, based on an analysis of tax data for 14 episodes (Van den Boogaard, 2018)[1] and similar analysis of fiscal data for 12 post-conflict episodes (Polchanov, 2017)[2]. That recovery, and so-called peace dividend, is quite idiosyncratic. Given that post-conflict capacity is usually constrained, tax reforms were frequently administrative in nature (for example, customs strengthening Mozambique) rather than major tax overhauls. One of the explanations may be that if government focuses on immediate higher tax revenues, tensions underlying conflict could be exacerbated (Collier 2009). In general, post-conflict taxation policy has been handled by focusing on longer term strengthening, modernising revenue administration to reap gains of digitisation and improving efficiency through tax enforcement to avoid need to increase tax rates or introduce new taxes.

Nonetheless, there have been a handful of cases where post-conflict fiscal policy was more transformative. Examples of using the post-conflict setting as 'windows of opportunity' include Nepal and Peru which experienced administration modernization and unprecedented revenue gains. (Van den Boogaard 2018). However, in a post-conflict setting, sustained tax revenue increases from reforms often took ten years, for example, Liberia. (Akitoby 2020)

Given the temporary nature of some reconstruction expenditures, efforts can be made to match these with temporary increases in fiscal resources. One example is temporary taxes with defined expiration dates. For example, Solomon Islands introduced a targeted amnesty relieving taxpayers who voluntarily disclosed underreporting from penalties and an increased focus on arrears collection (1 percent of GDP). (Akitoby 2020).

Another example of revenue measure with short-term impact is acceleration of planned programs of asset divestiture. One major asset class relates to natural resource extraction. However, given the potential to exacerbate conflict depending

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[1] Angola, Bolivia, Burundi, Congo, Eritrea, Kuwait, Liberia, Libya, Morocco, Nepal, Nicaragua, Peru, Rwanda, Salvador, Sierra Leone

[2] Angola, Cambodia, Congo, Croatia, Georgia, Indonesia, Liberia, Macedonia, Serbia, Sierra Leone, Solomon Islands, Tajikistan

on sub-regional location of resources, this needs to be approached with caution. An example where rules of sharing of natural resource rents contributed to peace is in Aceh region of Indonesia. Local authorities were given 70% of hydrocarbon deposits revenue as part of the peace agreement (Polchanov 2017). While in general sale of rights to resource extraction is the most promising way to levy taxes (compared with mere export of the commodity or taxing profits of firms) and auctions as the best method, it might be advisable to not sell rights for long term horizon because in the early post-conflict years, the discounts associated with post-conflict uncertainty can result in market value of more distant rights of extraction only a small fraction of their eventual worth (Collier 2009).

Sometimes in desperation for resources in the short-term to match immediate expenditure needs, government might sharply increase taxes on agricultural export commodities. However, this has been shown to slow movement back from subsistence farming which often had occurred during conflict (Collier 2009).

Other tax measures appropriate to an emergency phase are identified in an IMF How-to-note. One is favouring collection points with a high concentration of collection, for example, imports and very large taxpayers. Another is applying additional levies on natural resources, banks and telecommunications enterprises. (IMF 2019). More generally, it may be time to consider an appropriate revenue framework for the ICT sector.

Role of capital flight and repatriation has also been analysed. If by the end of the war private portfolios have only partially adjusted to wartime conditions, the post-conflict economy may continue to haemorrhage capital until policy is improved and risks are reduced. Alternatively, the proportion of private wealth that is held abroad can constitute an enormous potential for accelerating recovery. For example, by the mid-1990s Uganda was attracting substantial repatriation. In post-conflict setting there is potential for repatriation of skills in addition to financial resources. Often returning diaspora build houses, raising questions of how to avoid Dutch disease associated with construction and how to tax. (Collier 2009).

Post-conflict governments also face the choice between continued inflation and reconstruction of the monetary base (Adam, 2008). Although GDP starts to recover in post-conflict period, the process takes many years and, given the legacy of conflict, money demand is likely to remain below its peacetime counterfactual. Without injection of aid, it is difficult to avoid continued reliance on some monetary financing of the fiscal deficit.

4. Thoughts on Fiscal Resources in Ethiopian Post-Conflict Setting

Here are some thoughts on implications for Ethiopia of the above literature review.

Tax reform 'windows of opportunity'. Based on evidence from other countries, recovery to pre-conflict fiscal resource levels may be expected without major changes. However, given the longer term need to enhance fiscal revenues and the shorter term need to finance reconstruction and recovery expenditures, it would be important to identify any transformative 'windows of opportunity' in taxation. Just as post-conflict context can assist in expenditure reform, what might be possible in tax reform given popular support and elite fragmentation that often accompanies end of conflict, for example, property tax and closing exemption loopholes?

Sale of assets. Given the Ethiopian government's divestiture plans, there may be opportunities to accelerate, such as mining rights or shares in public enterprises. However, it would be important to signal that these are not fire sales driven by fiscal needs and be mindful of conflict-related uncertainty among investors. Pricing safeguards could build on the government's successful experience with telecom divestiture, for example.

Repatriation. Already the government has begun to tap into potential for financial and skill repatriation of the Ethiopian Diaspora to supplement resources during the post-conflict period. Given heightened support from diaspora, it would be worth evaluating expanded access to sectors where the diaspora are likely to be efficient and competitive investors, such as finance and technology.

Inflation. With uncertainty on timing of restoration of aid inflows, there may need to be some continued reliance on monetary financing of the deficit. However, expectations on the aid front also are likely to drive money demand.

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