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## RESPONDING TO AFGHANISTAN'S DEVELOPMENT CHALLENGE

(An Assessment of Experience During 2002-2007 and  
Issues and Priorities for the Future)

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# **RESPONDING TO AFGHANISTAN'S DEVELOPMENT CHALLENGE**

## **AN ASSESSMENT OF EXPERIENCE DURING 2002-2007 AND ISSUES AND PRORITIES FOR THE FUTURE**

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## LIST OF ACRONYMS

ADB	Asian Development Bank	MTEF	Medium-Term Expenditure Framework
ADF	Afghanistan Development Forum	MTFF	Medium-Term Fiscal Framework
ANDS	Afghanistan National Development Strategy	NA	Northern Alliance
ARTF	Afghanistan Reconstruction Trust Fund	NATO	North Atlantic Treaty Organization
ASG	Afghanistan Support Group	NPPs	National Priority Programs
BPHS	Basic Package of Health Services	NSP	National Solidarity Program
CAO	Control and Audit Office	PAR	Public Administration Reform
CG	Consultative Group	PEFA	Public Expenditure and Financial Accountability
CPIA	Country Policy and Institutional Assessment	PFM	Public Finance Management
DDR	Disarmament, Demobilization, and Reintegration	PRGF	Poverty Reduction and Growth Facility
EC	European Commission	PRR	Priority Reform and Restructuring
GDP	Gross Domestic Product	PRT	Provincial Reconstruction Team
HIPC	Heavily Indebted Poor Countries	SMP	Staff Monitored Program
IAB	Independent Appointments Board	SOE	State-owned Enterprises
I-ANDS	Interim Afghanistan National Development Strategy	TA	Technical Assistance
IARCSC	Independent Administrative Reform and Civil Service Reform Commission	UK	United Kingdom
IDA	International Development Association	UN	United Nations
IFI	International Financial Institution	UNAMA	United Nations Assistance Mission in Afghanistan
IMF	International Monetary Fund	UNCAC	United Nations Convention Against Corruption
ISAF	International Security Assistance Force	USA	United States of America
JCMB	Joint Coordination and Monitoring Board	VCAs	Vulnerabilities to Corruption Assessments
LOTFA	Law and Order Trust Fund for Afghanistan	WB	World Bank
MDRI	Multi-lateral Debt Relief Initiative		



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## **ABSTRACT**

This paper assesses development policies and performance during the post-Taliban period in Afghanistan and also, based on lessons from experience, looks toward the future. It covers economic management and growth, public sector management and governance, development management and aid coordination, and sector policies and performance, but with an overall focus on the strategic linkages among the main components of the development agenda (security, reconstruction, economic growth, governance, state building, counter-narcotics). The paper finds that despite great variation across thematic areas and sectors, overall there has been reasonable progress since 2001. Certainly the situation would have been much worse, if not for the currency reform and macroeconomic stability; rapid economic growth and associated rises in incomes; payment of civil servants' salaries on an increasingly regularized basis; expansion of service delivery in some sectors (health, education); and significant rural small-scale infrastructure investments; as well as other achievements. However, there are areas where progress has been limited or lacking, such as most infrastructure (other than telecoms and roads), governance reforms (other than public financial management), and the broader enabling environment for private business in the formal sector. Moreover, a composite assessment does not do justice to changing trends and dynamics, which in several respects have turned in an adverse direction. In this context, the paper argues that some important windows of opportunity, particularly in the military and political spheres, were not adequately exploited. The paper puts forward priorities for future action, and concludes that some combination of additional resources and much better deployment and use of available resources will be required to improve development performance and avoid drift, slow progress, and backsliding which would carry grave risks over the medium term.

## **ACKNOWLEDGEMENTS**

This paper relies heavily upon other past and ongoing analytical studies on Afghanistan, a number of which are included in the List of References at the end. It also reflects conversations with and insights from numerous knowledgeable people, who unfortunately cannot be acknowledged individually as the list would be very long. Responsibility for the views and any errors in the paper rests solely with the author however. Research support provided by M. Khalid Payenda, inputs for Table 1 from Abdul Raouf Zia, and comments by Stephane Guimbert, Yoichiro Ishihara, Allan Kelly (Asian Development Bank), Birgit Hansl, and Jalpa Patel are gratefully acknowledged. The paper was processed by Juliet Teodosio. Overall guidance for the World Bank's economic analysis on Afghanistan has been provided by Sadiq Ahmed and Ijaz Nabi, and guidance from a country perspective by Alastair McKechnie and Mariam Sherman.

## EXECUTIVE SUMMARY

Afghanistan since the fall of the Taliban has faced a highly unusual, in many respects unique set of development challenges—extreme poverty and underdevelopment, very limited human capital, loss of state legitimacy and capacity, lack of rule of law, and the burgeoning illicit, mainly opium economy. This paper assesses development policies and performance during the post-Taliban period and also, based on the lessons from experience, looks toward the future.

### ECONOMIC BACKGROUND

Devastated by nearly a quarter-century of protracted conflict, Afghanistan at the end of 2001 faced a daunting challenge in reconstruction. However, as one of the poorest and economically most backward countries in the world even prior to the onset of conflict in the late 1970s, Afghanistan also faced enormous development issues which were inseparable from the reconstruction agenda.

*Afghanistan's economy.* The economy of Afghanistan in late 2001 was shaped not only by the pre-war legacy but by the long period of conflict, during which destruction of limited pre-war economic institutions and entrenchment of illicit and conflict-related economic activities and behaviors occurred. The Afghan economy stagnated (amidst severe fluctuations) during the period from the late 1970s until the end of the century, with little or no growth of real GDP. Given that institutions and modes of doing business tend to persist, the impact of the “conflict economy” on recent economic development has been profound.

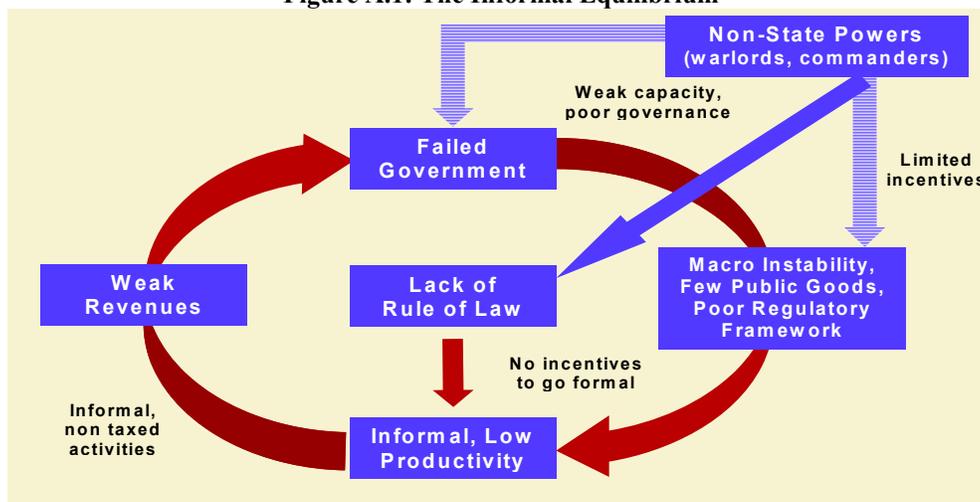
The economy is dominated by the informal sector which (including illicit activities) has been roughly estimated to account for 80-90% of total economic activity. Weak state capacity and lack of rule of law combine with the large informal/illicit economy to generate an “informal equilibrium”, whereby incentives for development of formal sector businesses are weak and instead the incentives to stay informal tend to be dominant (see Figure A.1 below). This vicious circle is self-perpetuating and generates a strong constituency hostile to the strengthening of the government. The informal economy has exhibited dynamism and plays an important role in absorbing excess labor, but it does not in itself provide a solid foundation for future economic growth and employment generation. Afghanistan's human capital has been severely depleted by destruction (deaths and injuries), displacement (flight of refugees and emigration), and most important dismally low investment in human capital during the past 30 years. Correcting this will take several decades. The country appears to be suffering from “Dutch Disease”, reflecting large inflows of drug proceeds, aid, and possibly also remittances, as well as the scarcity of literate, trained, and especially professionally qualified labor. Wages for skilled and professional labor are very high, and unskilled wages are driven up by the labor-intensive opium economy.

Reflecting a combination of Dutch Disease, investment climate problems, the dominance of opium, and other issues, Afghanistan's economy does not produce a sustainable gross domestic product with strong growth and export potential. Past export markets have been eroded or lost, or in some cases shifted into the informal sector with lower levels of quality and value. Import substitution has been occurring to a much more limited extent than might have been expected given high demand for and imports of goods which have been produced in the past in Afghanistan, and/or are relatively easy to produce with low levels of investment, are transport-protected due to high weight-value ratios, etc. Overall, this is a high-cost, high-risk economy for investment, employment, and growth in the formal sector.

Amidst these problems and constraints, there are some positive features. First, Afghanistan has an entrepreneurial population. Second, the country by and large maintains a market-oriented and unrestricted environment for the private sector, and rigid labor laws are not a constraint on economic activity and

employment. However, at the level of the government bureaucracy—in particular at lower levels and in day-to-day transactions—there tends to be hostility and corruption rather than positive cooperation between government and business. Third, the informal sector itself could be a source of great economic dynamism, if it is harnessed through appropriate incentives and faces a conducive business environment for “formalization”. Fourth, high economic growth over the past six years has generated strong demand.

**Figure A.1: The Informal Equilibrium**



**Key development objectives.** As in any country, medium-term growth will be critical for Afghanistan to generate productive employment, raise per-capita incomes, and reduce poverty in a sustained manner. A second key development objective is state-building. Afghanistan will not be able to achieve sustained development without a reasonably functional, effective, accountable state. This in turn requires good governance, adequate institutions, financial resources (ultimately domestic revenue mobilization to pay for core state functions), human capacity, and sound processes and management including not least to maintain a reasonable degree of integrity. The profile of poverty itself is a challenge for poverty reduction, the ultimate development goal. Pursuing these development objectives is made far more difficult by the continuing and expanding insurgency in the South, chronic insecurity and lack of rule of law, the burgeoning opium economy, and political tensions in addition to the conflict with the Taliban.

**Chronological summary.** As detailed in the paper, the period since late 2001 has been eventful for Afghanistan, including many positive developments (but, as will be noted later, also some lost opportunities), especially during the 2002-2004 period. These culminated with the Presidential election in late 2004 and included achievement of most of the ambitious targets of the 2001 Bonn Agreement, largely within the stipulated time-frame. Since 2004 trends have been more mixed, including among others continuing expansion and improving implementation of major national development programs and further increases in domestic revenues, but also political drift, revival of the Taliban and expansion of their insurgency, and further massive growth of the opium economy.

## **PRELIMINARY ASSESSMENT OF THE PAST SIX YEARS**

Given the time that has elapsed since the momentous developments of late 2001, a meaningful review of economic and development management, policies, and performance is now possible, even if preliminary and tentative. The main findings (based on a more detailed rough indicative “scorecard” presented and discussed in the paper) are as follows:

- **Macroeconomic management has been a success story for Afghanistan**, including robust rapid economic growth, declining inflation (to single-digits), a successful currency reform, and effective management and resolution of inherited foreign debts.
- **Economic policies in other areas present a more mixed picture:** Afghanistan has a relatively liberal trade regime by regional standards, but recently there has been some backsliding; the investment climate suffers from numerous problems, with private businesses naming access to land, electricity, and finance, and the issue of corruption, as the most important constraints to their activities; there has been some success in financial sector policies but failure to restructure and privatize state-owned banks.
- In public sector management and governance, **the greatest progress has been made in public finance management (PFM)**, including revenue mobilization and other budgetary trends as well as major improvements in the whole range of PFM processes and systems; however, these achievements have been based to a considerable extent on injection of temporary external capacity, so the challenge will be to maintain standards and make further improvements while shifting to sustainable core national capacity over time.
- **In public administration reform (PAR) performance has been considerably weaker** than in the case of PFM. The experience with the asymmetric Priority Reform and Restructuring (PRR) program has been mixed, with initially good results in some ministries and agencies but significant problems encountered—the mandated restructuring in many cases was only *pro forma*, and merit-based selection for positions frequently was observed in the breach. More recently the focus in PAR has shifted toward more comprehensive civil service reforms, including most notably pay and grading reform which would raise and sharply decompress pay levels for civil service positions, based on qualifications.
- **Capacity development remains a central issue that has not been well-addressed.** Much capacity has been “bought in” at high cost but has not resulted in building sustainable core capacity in Government, and there are widespread concerns about the quality, cost, management, and capacity building impact of Technical Assistance (TA).
- **Corruption by all accounts has increased greatly and has spread widely.** Anti-corruption efforts have been undermined by institutional disarray, apparently limited political commitment to take strong actions, and the sheer magnitude of the problem (including notably drug-financed corruption). Corruption is profoundly inimical to state-building and severely undermines Afghanistan’s development prospects.
- **Counter-narcotics efforts have not succeeded in reducing opium production** which on the contrary has soared to record levels, and moreover they have contributed to a consolidation of the drug industry around fewer, powerful, and politically connected actors, compromising elements of the Ministry of Interior and Police.
- **Security sector reform has been a problem area despite significant successes.** The Afghan National Army has been established and is being expanded, and the Disarmament, Demobilization, and Reintegration (DDR) process was completed for more than 60,000 “official” militia forces. However, numerous armed groups remain. Reforms in the national police have not made much headway. Afghanistan still lacks a comprehensive national security strategy. A particular concern is the cost and fiscal sustainability of decisions on and investments in the security sector.
- **Reforms and investments in the justice sector, which is key to rule of law and security, have lagged far behind**, with adverse ramifications for other important parts of Afghanistan’s development agenda, including private sector development.

Turning to development management, the main findings include the following:

- Since 2002 the Government of Afghanistan has produced a number of high-quality development strategy documents, but two issues have hindered meaningful development strategy formulation: (1) very limited consultation and dissemination for earlier strategy documents; and (2) a “needs assessment” approach without a resource envelope or explicit prioritization and sequencing.
- The Government has attempted with some degree of success to take leadership of development management (including aid coordination), but this has run into limitations and has fallen well short of what would be desirable. Leadership and management capacity also are a constraint in many line ministries. These problems reflect political fragmentation as well as Afghanistan’s high aid dependence.
- Aid management and coordination have been complicated by the large number of donors (as many as 62 according to Government reports); by most aid resources being channeled outside the Government’s budget and control framework; and by human resource constraints exacerbated by competition between the Government and international community over scarce Afghan skills.
- Insufficient priority has been given to development communication; there has been lack of emphasis on positive messages, and failure to dampen excessive expectations.

At the sector level, development performance not surprisingly has varied. Great progress has been achieved in Health (through implementation of the Basic Package of Health Services, BPHS, mainly by non-government providers), and in rural small-scale infrastructure and community development including through the National Solidarity Program (NSP). Telecommunications has been a major success story based on competitive private sector development of mobile phone systems, and rehabilitation and construction of roads has achieved significant progress albeit often at relatively high costs. But progress has been poor in the energy sector and also in most other infrastructure. There has been considerable social protection provided through humanitarian assistance, but without a strong strategy or effective Government programs for this purpose. Education has seen tremendous increases in access and in elementary school enrollments especially for girls, but there are serious concerns about the quality of education at all levels. Although different models of the role of the state and service delivery have been used in the various sectors, the most important determinant of performance has been the strength and cohesion of Afghan leadership in line ministries, which has been a dominant factor as compared with the *ex ante* quality, orientation, and amount of donor technical and financial assistance to different sectors.

Overall, this assessment of development policies and performance, based on a composite picture of the last 5-6 years, is reasonably positive. Clearly the situation would have been much worse, if not for the currency reform and macroeconomic stability; rapid economic growth and associated rises in incomes; payment of civil servants’ salaries on an increasingly regularized basis; expansion of service delivery in some sectors (health, education); and significant rural small-scale infrastructure investments, as well as other achievements. Development outcomes have been driven in the positive sense by rapid economic growth and increasingly effective service delivery in a few sectors like health, as well as massive expansion of elementary education. However, even after a substantial rise Afghanistan’s per-capita income remains very low, and its social indicators are still among the worst in the world. Moreover, there are some areas where the lack of progress has been striking. The broader enabling environment for private business in the formal sector is still quite weak; there are very serious problems with the governance agenda (other than PFM); and on the development management front the aid system remains to a large extent fragmented and chaotic, most aid goes outside government channels, and efforts by the Government to exert leadership have run into limits. At the sector level, there has been poor progress in major infrastructure development (other than highways). Lack of electricity, water, and other essential

services in many urban areas is not only a serious development issue but also gives rise to discontent. More fundamentally, the lack of security in many parts of the country, and limited rule of law, are very serious problems.

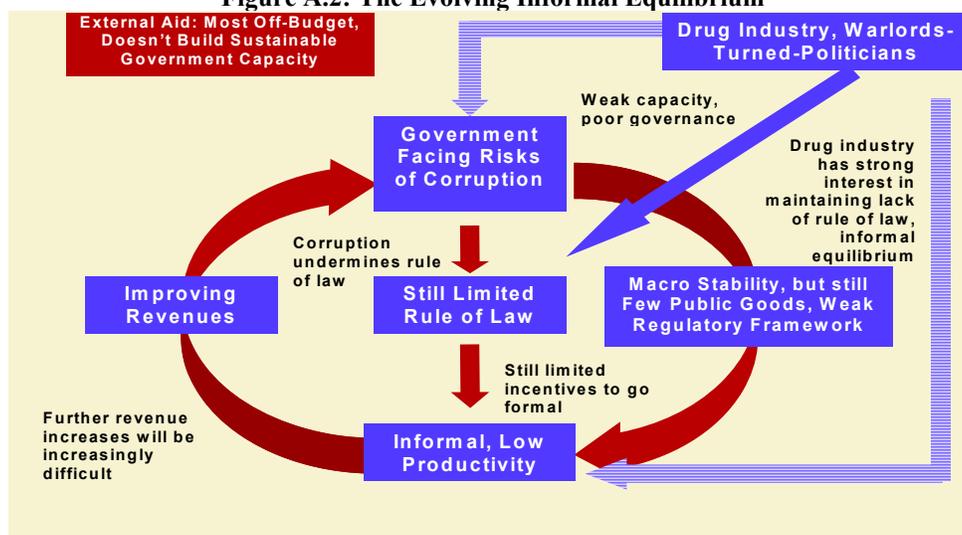
Afghanistan's current situation in terms of its institutions and policies for development can be evaluated on an internationally comparable basis using the World Bank's Country Policy and Institutional Assessment (CPIA) methodology. Afghanistan first participated in the CPIA process in 2006, and with a composite rating of 2.6 (on an ascending scale of 1 to 6) not surprisingly ranks 69<sup>th</sup> out of the 77 countries which are eligible for concessional support from the International Development Association and whose CPIA ratings are made public. This is well below other South Asian countries and in the same neighborhood as a number of low-income African countries affected by or recovering from conflict. Relatively good ratings for Afghanistan in economic management, trade policy, building human resources, and quality of budget and public financial management are offset by low ratings for most dimensions of social inclusiveness/equity (including gender equality) and public sector management and institutions (especially property rights and rule-based governance). The CPIA ratings indicate that despite considerable progress from an extremely low starting-point in late 2001, Afghanistan still lies close to the bottom globally in terms of the CPIA as well as economic and social indicators.

This assessment of Afghanistan's progress over the past 5-6 years is subject to several important caveats:

- First, progress has been assessed against the starting point in late 2001, based on a reasonable yardstick of significance, whereas what is relevant for Afghanistan's future prospects is whether progress has been adequate in relation to what the country needs to escape from the "conflict trap" of the 1990s and move forward on the path of sustained development. Progress in many areas clearly has not met such a more demanding standard.
- Second, progress and accomplishments, however real, are running far behind expectations—on the part of the population, politicians, government officials, and donors. Expectations were overly high at the outset, but failure to manage and dampen them has worsened the problem.
- Third, a composite picture does not do justice to changing trends and dynamics: in some areas important progress during the first 2-3 years was followed by slowdown, drift, or backsliding—adversely affecting future prospects.
- Fourth, success in exploiting different "windows of opportunity" in the post-2001 period has been varied, and in particular opportunities have been lost on the military and political fronts. Greater progress has been achieved in economic policy reforms than, for example, in sidelining warlords from Afghanistan's new politics, or in making the 2001 defeat of the Taliban "stick". While understandable, "satisficing" or "minimum effort" approaches carry grave risks in a situation where there are windows of opportunity. Moreover, during the "window" progress may appear relatively good even without too much effort, whereas this is not sustainable.

Turning to the changing dynamics of the situation, contrary to the desired shift from the "informal equilibrium" toward a situation where formal sector activity is encouraged, the informal equilibrium has been evolving, as depicted in Figure A.2 below. It suggests that some key aspects of the state building and formalization agenda are going off-track, and that overall progress is being threatened by (i) the emerging political patterns in which former warlords, commanders, and conflict-generated political groupings are playing a very important role; (ii) linkages of parts of the state and some politicians with the consolidating drug industry; (iii) the continuing and expanding insurgency; and (iv) the modalities by which most aid is delivered and the disappointing results achieved by much aid. State building in this context risks being distorted by corruption, political practices, and interest groups formed during the long conflict.

**Figure A.2: The Evolving Informal Equilibrium**



Both the opium problem and its adverse impacts on state building and development have worsened. The triangle between drug interests, their political and other sponsors, and parts of Government reflects a trend that—primarily through widespread corruption in implementation—counter-narcotics efforts have contributed to drug industry consolidation. Security forces, notably elements of the Ministry of Interior and the Police, are in part facilitating activities of the drug industry rather than countering it.

## KEY PRIORITIES FOR THE FUTURE

The paper also lays out priorities in several critical areas of the development agenda for Afghanistan.

***Sustaining economic growth and supporting private sector development.*** This is extremely important but will be especially challenging with some central elements of Afghanistan’s development agenda progressing slowly. While it is important to avoid directions and policies which, based on international experience and conditions in Afghanistan, are not likely to work, from a more positive perspective, some options for helping stimulating private sector-based economic growth include the following:

- ***More active exchange rate policy*** to mitigate the adverse impact of the Dutch Disease, but not beyond the point where it significantly increases inflation.
- ***Scaling up and maximizing the effectiveness of Industrial Parks***, which could at least on an enclave basis provide investors and entrepreneurs with security, access to land, infrastructure (power, water, convenient transport), and some insulation from red tape and corruption.
- ***Sharply raising local procurement by international military forces*** as well as pro-actively increasing local procurement in civilian aid. Only a tiny proportion of spending by international military forces at present is on goods produced in Afghanistan, and transparent, competitive local procurement could inject as much as \$1 billion annually into the Afghan economy and stimulate business development.
- ***Competitive contracting of international or regional firms to develop exports*** based on the full “value chain”, as well as other options for encouraging export development and international competitiveness.
- ***Privatization*** as a means of making the land and facilities of State-owned Enterprises available for the private sector.

- ***Encouraging critical business development and support services***, and effective, demand-based vocational training.
- ***A focus on the construction industry*** along with construction materials; this has great potential in view of the ongoing building boom.
- ***Business enterprise development including in rural areas***, to foster entrepreneurship and employment growth, including through linkages between farmers and agro-processing businesses.
- More generally, ***results-oriented productive cooperation between government and private sector***.

***Strengthening governance.*** Near-term priorities in this broad area, where progress will be difficult to achieve but will be essential, include the following:

- Progress in the fight against corruption will require demonstration of credible high-level Government commitment against corruption (manifested, for example, in a meaningful yet feasible action program of short-run measures); clarification of institutional arrangements so that the different actors work together harmoniously rather than competing over turf; and improvements in leadership where necessary.
- In public administration reform, the quality of implementation of the pay and grading reform will be critical, including most notably merit-based selection and appointment of civil servants. How to handle those civil servants who lack qualifications and/or are surplus to requirements in the new structure (they should not move onto the new salary system), and implications for civil service pensions, are other critical areas.
- Improving governance at sub-national level (provinces, districts, municipalities) is a priority that is receiving increasing attention. Within Afghanistan's unitary state structure as mandated by the Constitution, the way forward is de-concentration of responsibilities within centralized line ministries to provincial level and below, along with greater accountability for service delivery.
- In PFM, the priority is to maintain the momentum of earlier progress and to further strengthen PFM, including through progressively building sustainable capacity in Government to handle core PFM functions. Revenue mobilization and making increasingly difficult trade-offs on the expenditure side will be key.
- Finally, external and public accountability deserves more attention, including through making existing systems (external audit, Parliamentary reviews, etc.) work better.

***Responding to the challenge of the opium economy.*** This will require learning lessons from the rich experience with counter-narcotics efforts, including the following: (i) blanket eradication of opium poppy does not work beyond the short-run success achieved, resulting in shifts of cultivation to other places and/or a subsequent rebound in the area where it was eradicated; (ii) short-term alternative livelihoods programs are costly, wasteful, and unsustainable; and (iii) inevitable corruption in the implementation of counter-narcotics law enforcement measures results in distortions and can backfire. It should also be emphasized that the drug industry is by no means a static target but responds dynamically and effectively to actions against it. Counter-narcotics instruments inevitably are blunt and unwieldy in responding to a nimble and powerful adversary, calling for care and a strategic approach in deploying such instruments. A sound principle is to focus efforts against those parts of the drug industry that pose the greatest danger to the nation and its development agenda—i.e. the larger drug traffickers and their sponsors. A second principle is the need to take fully into account the adverse side effects and distortions of counter-narcotics instruments. Another issue that needs to be factored into the equation is avoiding perverse incentives,

which can be generated for example by focusing alternative livelihoods activities excessively on the major opium-producing areas and neglecting other areas.

Based on these principles, the following recommendations can be put forward:

- **Focus eradication efforts on better-off opium poppy cultivating areas and also areas that are new to poppy cultivation.** Experience suggests that eradication efforts can have a sustainable impact in such areas.
- **When a locality is targeted for eradication on this basis, go for complete or near-complete rather than partial eradication in that locality**—this will minimize the risk of corruption in implementation and associated distortions.
- Recognizing the political difficulties, **focus interdiction efforts against medium and larger drug traffickers and their sponsors.** This will set a positive example for counter-narcotics efforts at lower levels.
- Given the judiciary’s weakness and difficulties in successfully prosecuting major drug figures (despite some progress in establishing special counter-narcotics courts and training personnel), **actors associated with the drug industry should at least be removed from their positions in government**, which aside from any direct benefits will send a strong signal of credibility for the counter-narcotics strategy.
- **Do not throw money into short-term alternative livelihoods programs but rather support sensible rural development**, recognizing that this will take time.
- Don’t concentrate efforts and resources too much in the main opium producing areas, but rather **consider a kind of “containment” strategy to progressively close off large parts of the country from vulnerability to opium.**
- **Mainstreaming of the counter-narcotics dimension into development programs is very important** and will help in scaling up efforts on the development side. However, mainstreaming should be approached in a flexible and results-oriented manner.
- **Equally important is the need to “mainstream” development and governance considerations in counter-narcotics strategy and actions**, which makes very good sense and could help avoid many of the problems encountered in the recent past.

**Improving Development Management and Aid Effectiveness.** This will be a critical success factor for Afghanistan’s development agenda as well as for attracting, allocating well, and utilizing effectively international assistance.

- A first priority is **strengthening the leadership of line ministries whose development performance has been lagging**, which based on Afghanistan’s experience can be expected to result in improved outcomes in the sectors concerned.
- A second priority is **continuing to enhance the budget process and the role of the budget as the central instrument for policy and reform** as well as public sector resource allocation. Strengthening the medium-term orientation of the budget (through better utilization and further improvement of the Medium-term Fiscal Framework, or MTFF) and more effective prioritization will be critical in this regard.
- Finally, a key medium-term objective is **progressing toward fiscal sustainability**, which can be defined in the context of Afghanistan as a situation where domestic revenues are basically sufficient to cover budgetary operating expenditures.

Turning to aid management and coordination, there is much that needs fixing, and lessons from the experience of the past five years appear not to be getting fully absorbed; on the contrary there are signs of reversion to practices that had already been demonstrated not to work well during the early period of Afghanistan's reconstruction.

Although preparation of the Afghanistan National Development Strategy (ANDS) is moving forward with the objective of finalizing it in early 2008, the interface of the ANDS process with aid coordination and the process for monitoring the implementation of the Afghanistan Compact and the Joint Coordination and Monitoring Board (JCMB) set up for this purpose raises some issues. Options for improving these processes and interfaces include the following. First, the ambitiousness of the ANDS needs to be tempered by the time and resources available. The focus should not be on the quality of the ANDS as a document, but rather on preparation of a pragmatic, feasible, and prioritized strategy. Second, monitoring of Compact Benchmarks needs to be guided by ANDS sector strategies and to focus on their substance and results. Third, oversight of implementation, monitoring, and follow-up with respect to the ANDS once it is completed should be the responsibility of regular institutions of Government. Fourth, there is a need to streamline what has become a rather burdensome, meeting-intensive, and mechanical process of donor coordination. The number of meetings held under the JCMB/Compact monitoring process should be drastically reduced. Moreover, the approach should be much more problem-solving in character. Fifth, aid coordination would benefit from much more focus on implementation; coordination should devolve to the Working Groups where meetings would be informal, with only a single Consultative Group to discuss major issues. And finally, where there are bottlenecks in the line ministries, the focus should be on making necessary changes in them, rather than trying to cover the gap through aid coordination meetings, with little prospect for success.

Better organization and management of technical assistance (TA) is critical, and there is an urgent need for improvements. TA should not be thrown at problems in an ad hoc manner; under such circumstances it is likely to worsen the situation or become part of the problem. Government leadership and oversight of TA is essential. Finally, public communication on development aspects, both by the Government and on the part of donors, urgently needs attention, resources, and drastic improvements.

## CONCLUSIONS

Key lessons and principles that emerge from Afghanistan's experience include:

- Take fully into account the context specificity of each country situation, listen to local actors, and build adequate country knowledge.
- Keep a medium-term time horizon in perspective, even when taking short-run actions.
- Exploit windows of opportunity that arise, whose length and timing will vary for different elements of the development agenda.
- Go beyond "satisficing" or "minimum effort" approaches, which let problems fester.
- Strategic integration of the main dimensions of the overall agenda—state-building, security, governance, counter-insurgency, counter-narcotics, economic development—is essential; moreover this must also encompass understanding the dynamics and thinking ahead through scenarios and contingencies.
- Government leadership of the development agenda is critical and needs to be actively pursued; government weakness and lack of capacity must not be made into an excuse to bypass government. In particular, the quality of leadership teams in key line ministries needs to be improved where necessary.

- The Paris Declaration on Aid Effectiveness provides guidance for assessing aid management and coordination, including use of national systems, and transparency and information sharing.
- Aid should be increasingly channeled through the national budget, with appropriate fiduciary mechanisms as needed.
- Coordinated rather than fragmented interventions should be made by the donors on key issues when necessary and where there is an urgent need.
- Prioritization is critical—difficult but must be pursued, with Government in the lead.
- Avoid bilateralism in aid coordination (e.g. self-designated “lead donors”).

In conclusion, the state building agenda is central, but state building loses much of its lustre and *raison d’être* if it involves building a state severely undermined by corruption—parts of which may be beholden to the drug industry or other criminal and anti-state interests on the one hand, and which is awash in petty corruption on the other hand. This would be detrimental to service delivery, rule of law, and other national objectives, but most notably to the credibility and legitimacy of the state. In this context, the accelerated move toward “normal” political institutions also brought significant problems and side effects. Political power is still to a large extent based on past conflict-induced patterns, and there has been a failure to address the difficult legacies and human rights violations of the turbulent final two decades of the 20<sup>th</sup> century in Afghanistan. Thus strong efforts will be required to reduce the risk that what comes out of the state-building process is a corrupt state that does not effectively promote national development or provide services and has lost its credibility with most Afghans. Any expectations that Afghanistan in the near future will be able to build a state meeting developed-country standards are unrealistic, but adequate progress and reasonable minimum standards in terms of security and rule of law, good governance, and increasingly basic service delivery are essential. To complement “top-down” state building there is a need for “bottom-up” approaches based on public participation and monitoring.

The progress achieved by Afghanistan so far provides a platform for further progress in many areas. The areas where progress has been slow or negligible, and recent adverse trends, provide grounds for concern, however. Development and state-building inevitably will be a long-term effort, but much needs to be done in the short run, and we are left with the question of whether the effort as a whole is adequate in relation to the challenges faced. While more realistic expectations are called for on the part of all stakeholders than in the heady days immediately after the downfall of the Taliban, it also seems clear that the sum total of current efforts, as they are being implemented now, is insufficient to make continuing steady progress over the medium term. There is in the absence of substantial changes a serious risk of some combination of drift, slow progress, and backsliding. Such a scenario would carry grave risks over the medium term. Thus some combination of additional resources and much better deployment and use of available resources will be essential to improve development performance so that Afghanistan will move toward being in a sustainable position—development-wise, financially, capacity-wise, and in terms of the Government’s legitimacy and credibility.

## I. INTRODUCTION AND BACKGROUND

Afghanistan since the fall of the Taliban has faced a highly unusual, in many respects unique set of development challenges—extreme poverty and underdevelopment, very limited human capital, loss of state legitimacy and capacity, lack of rule of law, and the burgeoning illicit, mainly opium economy. Responding to these challenges has been a reconstituted, internationally and to a large extent domestically legitimate Afghan Government, together with the international community which has made a sizable political, military, and financial commitment. Afghanistan has thus become a demanding test case of the effectiveness of the international community’s interventions in conflict-affected low-income countries suffering from state disintegration.

This paper assesses development policies and performance during the post-Taliban period and also, based on the lessons from experience, looks toward the future. After outlining the enormous development challenge faced by Afghanistan, this first section provides background on the economy and key development objectives, followed by a summary chronological review of events since late 2001. Section II assesses policies and performance over the past six years, covering economic management and growth, public sector management and governance, development management and aid coordination, and sector policies and performance; it also provides a brief overall assessment and international comparison, as well as discussing some caveats that should inform and qualify the assessment. Moving beyond this composite picture, Section III delves into the dynamics of the evolving situation in Afghanistan and explores “windows of opportunity” in various dimensions, their timeframe, and the extent to which they have been exploited. Section IV discusses in some detail the main priority areas for the future, and the final section puts forward some lessons, principles, and recommendations.

### THE CHALLENGE

Devastated by nearly a quarter-century of protracted conflict, Afghanistan at the end of 2001 faced a daunting challenge in reconstruction. However, as one of the poorest and economically most backward countries in the world even prior to the onset of conflict in the late 1970s, Afghanistan also faced enormous development issues which were inseparable from the reconstruction agenda. In particular, restoration of the *status quo ante bellum* would not have been an acceptable strategy, for a number of reasons:

- First, the dislocations of war over a very long period of time—destruction of traditional livelihoods, displacement of people, rapid population growth, urbanization (including through long stays in refugee camps or cities of neighboring countries), monetization of the economy, growth of informal and illicit activities, and environmental degradation—meant that a return to the pre-war economy was not possible.
- Second, the pre-war Afghan economy could not have been a springboard for economic development. It was largely a subsistence economy albeit with some traditional exports (such as dried fruits and nuts, carpets). Moreover Afghanistan was not self-sufficient fiscally, requiring foreign aid to finance its public investments, following a long history of relying on external resources of various kinds (from conquest, and then payments from the British Empire).
- Third, the conflict had gone on for so long, and too much had happened globally during the period, for it to be viable to go back to the pre-war economy. Key developments included, constraints on agricultural trade (including non-tariff barriers and quality standards), the communications revolution, developments in transportation, and more generally an increasingly globalized world economy.

- Fourth, the pre-war Afghan state had only a veneer of modernity, did not reach much beyond Kabul and a few other cities, and was oriented toward keeping the peace and maintaining order rather than service delivery or development. Expectations of what the state should do have become far higher since the 1970s.
- And finally, “reconstruction” without development would have left the country very poor and facing major vulnerabilities and risks of renewed conflict. This would have defeated the purpose of the international intervention in Afghanistan since 2001, which was not only to overthrow the Taliban regime but also to ensure that the country would not fall back into conflict and risk again becoming fertile ground for terrorist activities.

Overall, Afghanistan faced a situation in which reconstruction by itself would not have been meaningful but there was a massive development agenda—to steadily raise average per-capita incomes and move up from being a very poor low-income developing country (near the bottom of global development rankings) toward the higher end of the low-income range and eventually toward lower middle-income status. Pursuing this agenda has been greatly complicated by the rapid rebound of opium output in the two years following the effective but short-lived Taliban ban on opium poppy cultivation in 2000/01, which meant that economic development would have to occur in the context of shrinking and over time phasing out the country’s leading economic activity (opium).

## **BACKGROUND ON THE ECONOMY**

The economy of Afghanistan in late 2001 was shaped not only by the pre-war legacy but also by the long period of conflict, during which destruction of limited pre-war economic institutions and entrenchment of illicit and conflict-related economic activities and behaviors occurred (Rubin 2000). Based on available data and estimates, the Afghan economy stagnated (amidst severe fluctuations) during the period from the late 1970s until the end of the century, with little or no growth of real GDP (Guimbert 2004). Given that institutions and modes of doing business tend to persist, the impact of the “conflict economy” on recent economic development has been profound. Some key stylized facts about the Afghan economy are outlined below:

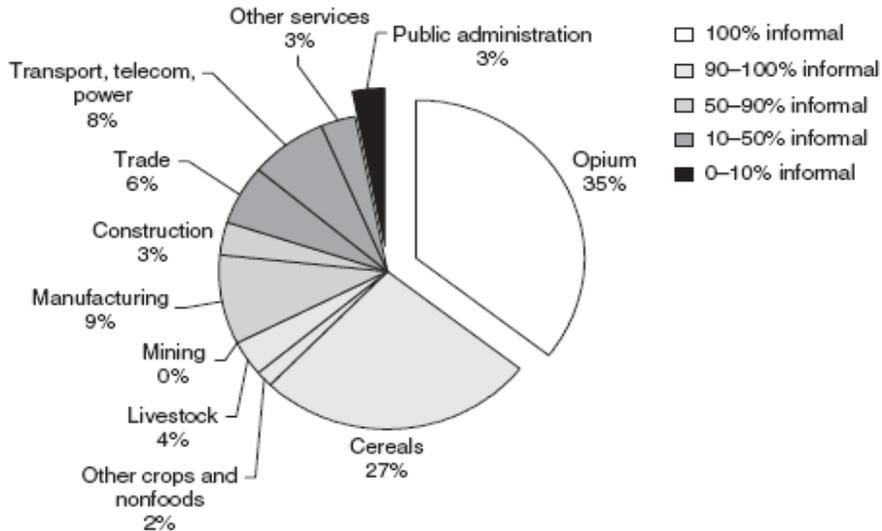
Afghanistan’s economy is dominated by the informal sector (including illicit activities). It has been roughly estimated that 80-90% of total GDP (including opium) is accounted for by the informal sector (World Bank 2005b, Chapter 1). As can be seen from Figure 1, not only is the informal sector dominant in agriculture as would be expected, but it is also very important in mining, manufacturing, construction, trade, and infrastructure. This reflects not so much excessive government regulation and red tape (although corruption appears to be widespread and increasing), but even more the lack of basic rule of law and a poor investment climate that resulted from state erosion and loss of capacity as well as infrastructural and financial constraints and insecurity. The informal economy encompasses a wide spectrum ranging from activities which are fully legal (although perhaps evading registration requirements and/or tax liabilities) to those which are illicit in the way they are conducted (not necessarily in themselves) and at the extreme those which are outright illegal (notably narcotics).

Weak state capacity and lack of rule of law combine with the large informal/illicit economy to generate an “informal equilibrium”, whereby incentives for development of formal sector businesses are weak and instead the incentives to stay informal tend to be dominant (World Bank 2005b, Chapter 1). Breaking out of this vicious circle comprises a critical element of the overall development agenda, leading to sustained growth of economic activities in the formal sector and associated employment growth.<sup>2</sup>

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<sup>2</sup> The informal sector exists in all countries, although at high levels of average per-capita income it tends to be relatively small as a share of GDP. What is largely missing in Afghanistan is a significant, dynamic formal sector.

**Figure 1: Rough Estimates of the Informal Economy in Different Sectors**



*Note: Percentage figures refer to the share of each sector in total GDP, shadings to very rough estimates of the percentage of the informal economy in the sector concerned. Source: Based on World Bank (2005b: 7).*

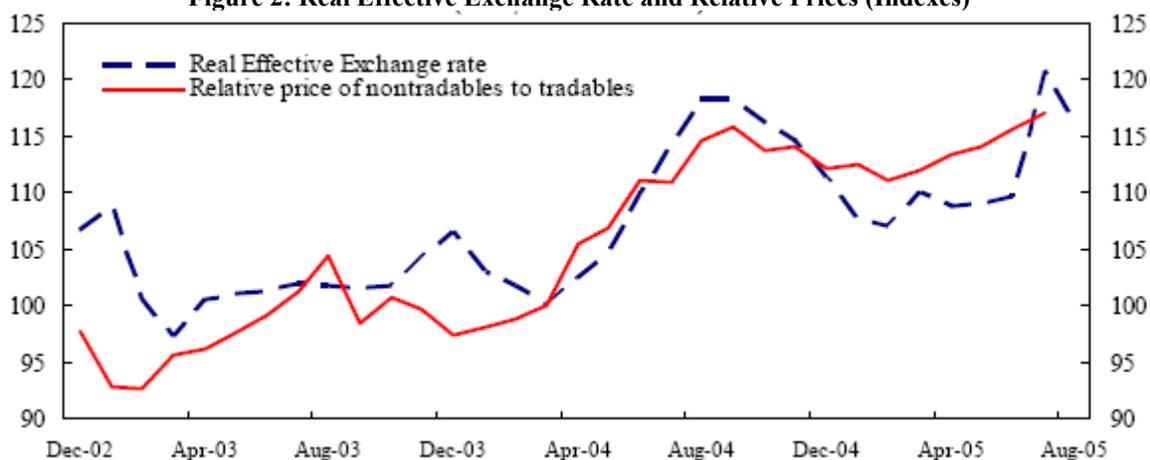
Afghanistan’s human capital has been severely depleted by destruction (deaths and injuries), displacement (flight of refugees and emigration), and most important dismally low investment in human capital during the past 30 years. Correcting this will take several decades. Currently, high demand for some forms of labor (including from the international community in Afghanistan) does not seem to translate into sustained high employment growth, but rather into high wage rates which even attract skilled labor from neighboring countries. The shortfall in human capital is manifested strikingly in weak government capacity, despite improvements in some respects in recent years. Although structures and civil servants are in place, the effectiveness of government has been limited in most respects.

The country appears to be suffering from “Dutch Disease”, reflecting large inflows of drug proceeds, aid, and possibly also remittances, as well as scarcity of literate, trained, and especially professionally qualified labor. Wages for skilled and professional labor are very high, and unskilled wages are driven up by the labor-intensive opium economy. Trends in the foreign exchange rate for the Afghani up to 2005 manifest symptoms of the Dutch Disease, and trends in the relative price of non-tradables to tradables have been similar (see Figure 2). With domestic inflation running higher than global inflation and the exchange rate holding steady against the US dollar, Afghanistan’s currency has been appreciating in real terms. International experience strongly suggests that chronic overvaluation of the exchange rate is not good for economic growth.<sup>3</sup>

Reflecting a combination of Dutch Disease, investment climate problems, the dominance of opium, and other issues, Afghanistan’s economy does not produce a sustainable gross domestic product with strong growth and export potential. Past export markets have been eroded or lost, or in some cases shifted into the informal sector with lower levels of quality and value. Import substitution has been occurring to a much more limited extent than might have been expected given high demand for and imports of goods which were produced in Afghanistan in the past, and/or are relatively easy to produce with low investment, are transport-protected due to high weight-value ratios, etc.

<sup>3</sup> The Dutch Disease and real exchange rate movements for Afghanistan are analyzed in IMF (2006: 7-23). Rodrik (2007) provides an overview and analysis of the relationship between the real exchange rate and economic growth. For a recent analysis of real exchange rate trends in the context of post-conflict aid, see Elbadawi *et al* (2007).

**Figure 2: Real Effective Exchange Rate and Relative Prices (Indexes)**



Overall, this is a high-cost, high-risk economy for investment, employment, and growth in the formal sector. Despite high demand, and with the notable exception of mobile telecommunications, expansion of the formal sector has been more limited than the overall growth of the economy would imply. According to the first investment climate survey conducted for Afghanistan (see World Bank 2005c), formal-sector business firms perceive that access to land, electricity, and finance, as well as the problem of corruption, comprise the most important constraints to their activities. Insecurity and lack of rule of law also are seen by most observers as major constraints, deterring many investors from setting up formal-sector businesses in the first place.

The informal economy has exhibited dynamism and plays an important role in absorbing excess labor, but it does not in itself provide a solid foundation for future economic growth and employment generation. It is not conducive to technological modernization and productivity improvements; incentives to invest in training are limited; size of business enterprises tends to be severely constrained; sustained export development is hard to generate (quality standards, getting around non-tariff barriers, insurance, etc.); and the learning by doing associated with formal sector activities does not occur (and nor is there strong demand for modern business services).

Amidst these problems and constraints, there are some positive features:

- Afghanistan has an entrepreneurial population—the long period of conflict and the refugee experience of many Afghans made many of them even more entrepreneurial. This characteristic, combined with the vibrant informal economy, enabled most Afghans to survive in an extremely difficult conflict-affected environment. The refugee population also built up significant human capital, comprising a valuable resource that can be brought to bear for development.
- Afghanistan by and large maintains a market-oriented and unrestricted policy environment for the private sector. This includes for the most part relatively low import tariffs, few non-tariff barriers, relative ease of establishing new enterprises, sensible laws and regulations, etc. Macroeconomic stability provides a cornerstone for private sector development and employment growth. However, it must be recognized that at the level of the government bureaucracy—in particular at lower levels and in day-to-day transactions, and individual business firms, there tends to be hostility and corruption rather than neutrality let alone productive cooperation. Businessmen complain about widespread bribery, harassment, and red tape, whereas government officials tend to see private businesses as having a mind-set overly oriented toward short-term profits as

opposed to longer-term investment and employment generation and, in the case of corrupt officials, as sources of cash to be exploited.

- As shown in Afghanistan’s Investment Climate Assessment, rigid labor laws are not a significant constraint on economic activity and employment in the private sector (unlike in the public sector, where there are strong protections for employees).
- The informal sector itself could be a source of great economic dynamism, if it is harnessed through appropriate incentives and faces a conducive environment for “formalization”. It is important to transform the entrepreneurship, flexibility, and responsiveness to shocks demonstrated by Afghanistan’s informal economy into sustained growth drivers in the formal sector.
- Fifth, economic growth has been well into double-digit rates over the last five years (see later discussion and also Figure 3). Even though this includes a large element of recovery after the long period of conflict and from the severe drought of the late 1990s, and it is based to a considerable extent on one-time or unsustainable growth drivers, such growth has provided an environment of high demand conducive for employment growth and business enterprise development. However, as growth settles down to lower levels, this advantage will decline.

This mélange of stylized facts and weaknesses, combined with some potential opportunities, makes overall for a highly unusual, in many ways virtually unique economy with formidable challenges. This calls for well thought-out, innovative, effective, and flexible economic policies and development approaches in response.

## **KEY DEVELOPMENT OBJECTIVES**

As in any country, the medium-term growth agenda is critical for Afghanistan to generate productive employment, raise per-capita incomes, and reduce poverty in a sustained manner. Maintaining rapid economic and employment growth will be all the more important because it is expected that a large, dynamic, and labor-intensive component of the economy—the opium sector—will decline and will be phased out over time (Afghanistan Government and International Agencies 2004). At the same time, the forces driving recovery in the early post-Taliban years are expected to weaken. Thus new, sustainable “growth drivers” need to emerge. Intimately related to the challenge of sustaining economic growth is the need to build the competitiveness of Afghanistan’s economy, not least so that exports can over time replace aid and drugs as sources of foreign exchange for the country’s balance of payments. This is closely related to the formalization agenda, as sustained growth of licit exports and improvements in competitiveness require the development of a healthy and efficient formal sector.

A second key development objective is state-building. Afghanistan will not achieve sustained development without a reasonably functional, effective, accountable state. This in turn requires adequate institutions, financial resources (ultimately through domestic revenue mobilization to pay for core state functions), human capacity, and sound processes and management including not least to maintain a reasonable degree of integrity. State-building is a tall order, but it will be essential for the overall success of Afghanistan’s development. In particular, complementary public inputs (infrastructure, regulation, rule of law and security, etc.) are prerequisites for sustained private sector-based economic growth in the formal sector. And effective service delivery will be critical for building Afghanistan’s human capital.

Good governance comprises an essential element of the development agenda and is closely related to state building. This ranges from broad systemic aspects of the political structure to control of corruption, transparency and citizen participation, basic government functions like border control, and effective

delivery of services, including not least in the Afghanistan context security and a modicum of rule of law—but there is also high popular demand for basic social services as well as functioning infrastructure.

The profile of poverty itself is a challenge for poverty reduction, the ultimate development goal. Based on the national household survey, Afghanistan's poor are overwhelmingly illiterate, tend to be located in more difficult topography and remote areas, have little land and other agricultural assets, tend to grow staple crops rather than horticultural products, suffer from very low health indicators, are often highly vulnerable to shocks as well as to seasonal patterns of income, and must juggle marginal income-earning opportunities to make ends meet. Moreover, there appear to be difficult geographical pockets of poverty. Although income inequality in Afghanistan appears not to be very high compared with patterns in many other low-income developing countries, recent trends are not yet clear. Moreover, this means that there are very large numbers of people around the poverty line, and that as a result a large portion of the population is vulnerable to economic or other shocks that would drive them into poverty.

Pursuing Afghanistan's development objectives is made far more difficult by the continuing and expanding insurgency in the South and East, chronic insecurity and lack of rule of law, and political tensions aside from the conflict with the Taliban. These in turn are related to limited state functionality as mentioned above, the multi-faceted problems associated with the opium economy, and issues around political normalization, which has made a great deal of progress in a formal sense but also appears to have inadvertently entrenched conflict-related elites and political practices.

## **CHRONOLOGY AND MILESTONES**

Starting from an extremely challenging situation in late 2001, a great deal has happened, and considerable progress has been achieved (assessed in Section II). Table 1 provides a chronology of significant events, highlights of which are outlined below.

The initial period in late 2001 and early 2002 saw the (surprisingly quick) downfall of the Taliban, the (not surprising) advantage taken by warlords and factions of their alliance with the US/Coalition, the (surprising, and under the circumstances remarkable) conclusion of the Bonn Agreement to guide the political normalization process, and the Tokyo reconstruction conference in January 2002 which elicited substantial initial pledges of reconstruction assistance from the international community.<sup>4</sup> Following this, and quite early during the reconstruction process, the Government produced a draft National Development Framework in April 2002, which set forth main themes and overall priorities to guide development work.

The Emergency Loya Jirga in June-July 2002 established a recognized transitional government, but many felt that an opportunity to sideline warlords and militia faction leaders was lost, as even those who did not apply and were not selected to be members of the Loya Jirga were in the end invited to participate and played a very prominent and visible role. Nevertheless, there was space created for appointment of several highly qualified and pro-active technocrats in the transitional government's Cabinet.

There was an important shift from donor-led aid coordination to a Government-led Consultative Group process. In June 2003 the first annual meeting of the Afghanistan Development Forum was held. During

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<sup>4</sup> Although the amounts pledged in Tokyo were much less than what was actually required and later spent (and this was criticized at the time by the Government of Afghanistan), the *Securing Afghanistan's Future* exercise conducted in late 2003 and early 2004 provided a more systematic assessment of development requirements which was endorsed at the Berlin reconstruction meeting in February 2004. It was important to hold the Tokyo meeting very early and get a strong and highly visible international commitment to Afghanistan's reconstruction, even if the amounts were based on a very rough preliminary needs assessment, which could be revised later. Moreover, absorption capacity for aid was limited at the outset and constrained spending within levels well below the amounts pledged initially.

late 2002 and early 2003 the highly depreciated currency was replaced with a new, stable currency. This, together with the Government's consistently honored commitment not to resort to domestic borrowing to finance the budget deficit, laid a solid foundation for macro stability and declining inflation.

Late 2003 and early 2004 saw the design of Afghanistan's new Constitution and its approval by the Constitutional Loya Jirga, and the *Securing Afghanistan's Future* exercise which developed a revised assessment of Afghanistan's financial requirements (external assistance of \$28 billion over seven years) that was presented at the Berlin donor meeting in February 2004 and broadly endorsed by the international community.

**Table 1: Selected Chronology of Events—Focused on Development and Aid (2001-2007)**

Month/Date	Event/Development	Comments
<b>2001</b>		
October 7	US/Coalition military action against Taliban starts	War against Taliban relied mainly on Afghan anti-Taliban ground forces plus US airpower
November 13	Northern Alliance (NA) forces take Kabul	NA became entrenched in central government, initial setback to political normalization and reforms
November-December	Reconstruction meetings in Washington, Islamabad, Berlin, Brussels	Many donor-driven meetings, but generated visibility, momentum, and interactions among aid community
December 6	Bonn Agreement signed	Major achievement, but victors' agreement; Taliban not represented, they did not surrender, so not a peace agreement
December 7	Taliban give up last stronghold of Kandahar	Conventional military defeat of Taliban came much more quickly and easily than most had expected
December 22	Interim Administration established in Kabul	Started out in an extremely weak position in the face of military and political dominance by NA
<b>2002</b>		
January 1	First contingent of foreign peacekeepers in place in Kabul	The decision not to expand International Security Assistance Force (ISAF) beyond Kabul in the initial period had important implications
January 21-22	Tokyo high-level meeting on Afghanistan's reconstruction	Preliminary needs assessment hurriedly prepared by international agencies, basis for aid pledges for two and a half years
January-June	IFIs' re-engagement, first missions, setting up offices; first set of WB emergency operations	Rapid response by IFI standards; important bilateral donors and EC moved even faster
March 28	United Nations Assistance Mission in Afghanistan (UNAMA) set up to integrate and lead UN support	Decision was made to have a UN "light footprint" i.e. no UN government, but UNAMA to coordinate
April	Draft National Development Framework	Important preliminary Government strategy document
May	Afghanistan Reconstruction Trust Fund formally established	ARTF became primary instrument for financing civilian recurrent budget; Law and Order Trust Fund for Afghanistan (LOTF) separately paid police salaries
June 10 -16	Emergency Loya Jirga (Grand Assembly) met and established transitional government	Warlords were allowed into the process, opportunity to marginalize the worst of them may have been lost
September 5	Currency reform initiated	Bold move, taken against international advice
September	National Solidarity Program and five other National Priority Programs (NPPs) launched	Although only some of the initial NPPs took off, this was clearly the right direction to develop credible programs
October	President Karzai appointed the Constitutional Commission	Commission of 35 members was assigned to draft a new Constitution for Afghanistan after almost two decades
December	Final Afghanistan Support Group meeting; ASG wound up	Parallel official aid coordination processes ended, Government-led Consultative Group process put in place
<b>2003</b>		
Late 2002-early 2003	Afghanistan's arrears to main multilateral institutions (WB, ADB, IMF) cleared	Regularized Afghanistan's relationship with IFIs and enabled resumption of normal aid (including lending)
January	Currency reform successfully completed	This and "no-overdraft" policy that has been consistently honored provided the foundation for macro stability
February 1	First Provincial Reconstruction Team (PRT) established in Gardez	Other PRTs established later; PRTs have a few troops & political, security, and development staff; billed as ISAF expansion, but direct security role largely symbolic
June	First Afghanistan Development Forum (ADF)	Apex of CG process, solidified government leadership
August 11	NATO takes over ISAF	Unprecedented expansion of NATO military role beyond European area of operations
December 13	Constitutional Loya Jirga starts meeting	Contentious proceedings, took longer than expected

Month/Date	Event/Development	Comments
<b>2004</b>		
January 26	Constitution promulgated	Major step forward, but unusual semi-Presidential form of government, voting system discouraged national parties, helped get many warlords elected to Parliament
March 31 – April 1	Berlin meeting on Afghanistan's reconstruction	<i>Securing Afghanistan's Future</i> exercise developed revised needs assessment, with estimated aid requirement of \$27.6 billion over seven years
October 9	Presidential elections	Hamid Karzai elected with about 55% of vote (against a large field of other candidates); in some sense represented the high-tide of progress since 2001
November	Major anti-drug campaign launched by President Karzai	Despite some short-term success in 2004/05, this cost the Government political capital, and opium production boomed in 2006 and 2007
December 7	Inauguration of Hamid Karzai as democratically-elected President of Afghanistan	President had strong powers (together with Cabinet) to legislate by decree until Parliament was elected
December	Transitional Government replaced by Islamic Republic of Afghanistan	Legitimate permanent government established, although legislative branch elections delayed
December 24	Significant changes in Cabinet	This and subsequent changes resulted in a more political and somewhat less reform-oriented Cabinet
<b>2005</b>		
May 11	Riots in Jalalabad and elsewhere sparked by reports of offensive treatment of the Koran in the US detention facility at Guantanamo Bay	Manifested popular discontent and problem of youth unemployment (possibly aggravated in Jalalabad by the counter-narcotics campaign in Nangarhar province)
Summer	Insurgency begins to noticeably worsen	Downhill slide and worsening insecurity in South
September 18	Elections for Parliament and Provincial Councils successfully held, but District Council elections indefinitely postponed mainly for logistical reasons	Elections brought many former warlords, criminal elements, drug figures, and people with allegations of war crimes and human rights abuses against them into Parliament and Provincial Councils
December 19	National Assembly inaugurated in Kabul	Completed the political normalization process mandated by the December 2001 Bonn Agreement
<b>2006</b>		
January 31 – Feb 1	London Conference, I-ANDS presented, Afghanistan Compact endorsed	Framework for continuing engagement of international community following completion of Bonn process
February 5	Riots in a number of cities over cartoons published in European newspapers with offensive depictions of the Prophet Mohammed	Provided an example of volatility, and that emotive issues could easily bring out crowds and result in violence
April	First quarterly meeting of Joint Coordination and Monitoring Board (JCMB), apex for monitoring progress under Afghanistan Compact	Initially meetings started out as somewhat mechanical and diplomatic, became more substantive over time; heavy burden of CG and WG meetings however
May 2	Parliament gives vote of confidence to 20 of 25 ministers appointed by President Karzai	Parliamentary approval of the remaining five ministers occurred on August 7, 2006
May 29	Riots in Kabul following major traffic accident involving Coalition forces	Brought home fragility of law and order situation even in Kabul
July	Major battles with Taliban in the south, all pitched battles won by NATO/ISAF	Although a Taliban takeover in the south was prevented, this was at a high cost in terms of civilian casualties
December 14	President Karzai formally launches Government action plan on peace, justice, and reconciliation	There had been earlier efforts to reach out to the Taliban, but this gained momentum as the insurgency intensified; NA opposed bringing Taliban into government
<b>2007</b>		
March 10	So-called "Amnesty Bill" for misdeeds during past conflicts passed by Parliament	Although watered down from its original form and applied to political groupings rather than individual, this nevertheless sent a worrisome signal
April 3	Formation of "National Front" party opposed to President Karzai	Response to perceived weakness of Government (some Cabinet initially joined National Front)
July	Decision point for Afghanistan's participation in Heavily Indebted Poor Countries (HIPC) Initiative	Approval by WB and IMF Boards paved way for later full bilateral and some multilateral debt relief

*Source: Author's selections; inputs from Abdul Raouf Zia and M. Khalid Payenda.*

The Presidential election in October 2004 was a high point in popular perceptions of the Government. With 55% of the vote against a large field of other candidates, President Karzai demonstrated that he was the only viable nationwide candidate, usually running second or third in any provinces where he did not win the popular vote.

In late 2004 political capital was expended on an anti-drugs campaign that achieved only temporary success, and changes in the Cabinet at year-end reduced the number of reform-oriented ministers. Riots in Jalalabad and elsewhere in May 2005, sparked by reports of offensive treatment of the Koran in the US detention facility at Guantanamo Bay, appeared to signal popular discontent and may also have reflected youth unemployment. Moreover, by the summer of 2005 the signs of Taliban resurgence in the south were unmistakable.

The legislative elections to the National Assembly and Provincial Councils were successfully held in September 2005, but the atmosphere had worsened significantly as compared with the Presidential election. Many ex-warlords, commanders of armed groups, their associates, criminal elements, drug traffickers, and people against whom there were serious allegations of war crimes and human rights abuses, were elected to the National Assembly and Provincial Councils.<sup>5</sup> This was partially offset by the one-fourth of seats reserved for women in the Lower House of the National Assembly.

Work on the Interim Afghanistan National Development Strategy (I-ANDS) came to fruition at the beginning of 2006. At the same time, an “Afghanistan Compact” was developed to guide the work of the Government and international community after the completion of the Bonn Agreement process. The Compact was broader in scope (encompassing the development agenda) and much more detailed in its benchmarks than the Bonn Agreement had been. Both the Afghanistan Compact and the I-ANDS were presented at a major international donors meeting in London on January 31 – February 1, 2006 and endorsed by the international community and by the Government.

Then came widespread riots in protest against the publication in European newspapers of cartoons depicting the Prophet Mohammed in an offensive manner. In May 2006 the Kabul riots (after a serious traffic accident involving US forces followed by shooting) highlighted the fragility of law and order even in Kabul. Most important, 2006 saw a major resurgence of the Taliban in the south and east, including pitched battles of a size not seen since 2001. Although the Taliban were defeated in every significant military encounter, civilian casualties and destruction of property were substantial.

In 2007 an expected Taliban “spring offensive” did not materialize, but there continue to be numerous security incidents, attacks on government and international forces, suicide bombings, destruction of schools, and the like. Moreover Taliban presence, at a level well below that of significant military engagements, is continuing and spreading to surrounding provinces.<sup>6</sup> There are also signs of other political tensions, including the Amnesty Bill (which weakens the Government’s responsibility to pursue and prosecute war crimes and human rights abuses), the formation of a new political party—the National Front—bringing together a number of anti-Taliban groups opposed to President Karzai, and Parliamentary no-confidence votes on several ministers.

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<sup>5</sup> According to one source, the National Assembly Lower House (Wolesi Jirga) of 249 members included some 40 commanders still associated with armed groups, 24 members of criminal gangs, 17 drug traffickers, and 19 persons facing serious allegations of war crimes and human rights abuses (reported in Wilder 2005: 14).

<sup>6</sup> Field research in some areas suggests that there are informal accommodations between the Taliban and local authorities, whereby the latter are left undisturbed in district headquarters while the former increasingly control the countryside. See Mansfield (2007: 29).



## II. PRELIMINARY ASSESSMENT OF THE PAST SIX YEARS

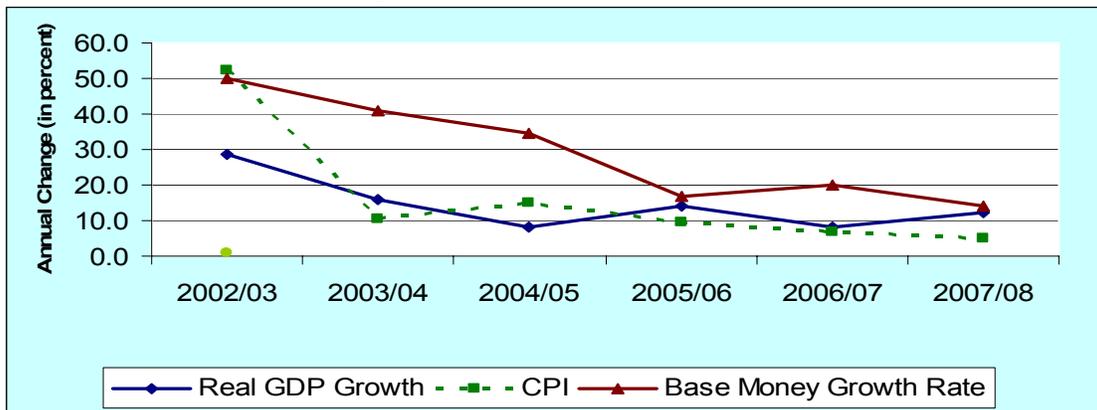
It has now been nearly six years since the political agreement reached at the Bonn Conference in December 2001 and since the preparation of an initial reconstruction needs assessment and the Tokyo conference on Afghanistan's reconstruction in January 2002; and well over five years since the World Bank and other international agencies came in with their first round of reconstruction assistance, and since the Emergency Loya Jirga established the transitional administration in July 2002. Thus sufficient time has elapsed to allow a meaningful review of economic and development management, policies, and performance, and to come to an initial assessment even if preliminary and tentative.

To distill such an assessment into convenient summary form, a rough indicative "scorecard" is presented in Table 2. This inevitably simplifies a much more complex, detailed, dynamic, and nuanced picture, but nevertheless it may be useful in identifying the areas where Afghanistan has done well and those where serious problems and blockages have been encountered. Ratings are provided both for management and policies in the areas concerned, and for outcomes. It should be noted that the ratings in the scorecard are based on progress achieved from the baseline situation in late 2001 to early 2002. The discussion below fleshes out the scorecard and highlights key findings.

### ECONOMIC MANAGEMENT AND GROWTH

Macroeconomic management has been a success story for Afghanistan, starting early on with the country's highly successful currency reform and a strong commitment to avoid domestic budget deficit financing (i.e. all spending exceeding domestic revenues had to be covered by external assistance). This latter commitment has been adhered to, and in combination with prudent monetary policy has resulted in a stable exchange rate and progressive decline of inflation from initially high rates (and hyperinflation in the 1990s) to single-digit levels in the past two years (see Figure 3). Afghanistan for several years successfully implemented a Staff Monitored Program (SMP) supported technically by the International Monetary Fund (IMF), and since 2006 has had in place a Poverty Reduction and Growth Facility (PRGF) with financial support from the IMF.

Figure 3: Macroeconomic Indicators



Note: 2007/08 figures are projections. Source: IMF, Afghanistan Central Statistical Office

**Table 2: Economic and Development Policies, Management, and Performance**

Category	Policy/ Mgmt Score	Out- come Score	Comments
<b><i>Economic Management</i></b>			
Macroeconomic Management	+	++	Sound macro policies targeted at low inflation; successful currency reform provided foundation for price stability; inflation has come down to single digits; concerns about “Dutch Disease”, high-cost economy
Fiscal Policy	+	++	Avoidance of domestic financing of the fiscal deficit; strong efforts to mobilize domestic revenue (although rate of revenue growth slowing); prudent control over total expenditure but increasing pressures
Trade Policy	+	0	Major rationalization of tariffs (which are low in regional context), with few non-tariff barriers; however, recent pressures for protection; trade facilitation is weak and problematic; export performance has been poor
Financial Sector Policy	0	-	Reforms have resulted in several private banks getting started, but the private sector still does not have much access to financial services, and limited progress has been made in restructuring state-owned banks
Private Sector Enabling Environment	0	-	Afghanistan maintains pro-private sector policy environment on paper, but there are obstacles of corruption and red tape, lack of access to finance and land, electricity etc.; progress in formal sector development limited
Policies for Economic Growth	-	+	Growth policies have been fragmented and do not comprise an effective growth strategy; double-digit economic growth so far, but serious doubts about sustainability and what factors will drive future growth
<b><i>Public Sector Management and Governance</i></b>			
Public Finance Management	++	+	Major improvements in budgetary process; credible fiduciary standards and financial controls; but improvements dependent to a large extent on temporary external capacity; PFM in line ministries remains weaker
Public Admin. Reform and Capacity Building	+	0	Significant progress through asymmetric reforms and development of a comprehensive PAR program, but limited success, sustainability of capacity building efforts; implementation of pay and grading reform will be key
Security Sector Reform	-	-	Good progress with Afghan National Army, but very slow reform of police; no national security strategy, and security has deteriorated in many areas
Justice Sector Reform	-	-	Lack of a sound sector strategy; little progress overall; institutions not functioning well, but recent improvements in leadership of some of them
Anti-Corruption Strategy and Policy	-	--	Strong, consistent Government public commitment against corruption, and some progress in PFM etc., but institutional disarray, and corruption by all accounts is widespread and has been increasing
Counter-Narcotics efforts	-	--	Sensible National Drug Control Strategy but fragmented and inconsistent CN activities; opium production has soared in recent years; signs of increasing consolidation and strength of drug industry
Political Normalization and State Building	+	0	Political progress in line with the Bonn Agreement of December 2001, but signs of dysfunctional political practices, “capture” of parts of the state via corruption associated with the drug industry, etc.
<b><i>Development Management and Outcomes</i></b>			
Development Strategy and Poverty Reduction	+	+	Compelling Government strategy documents since 2002, but need for prioritization, more consultations, and Government-wide ownership; currently working on ANDS to address these issues
Government Leadership	+	0	Strong Government efforts to exert leadership, but hindered by limited capacity, poor leadership in some sectors and line ministries, and donor practices and (in some cases) lack of donor buy-in
Aid Management	+	0	Government attempting to take the lead and to instill Paris Declaration approach, but limited success in improving the cohesion of off-budget aid or in shifting large amounts of aid on-budget
Donor Aid Practices	0	-	A minority of aid can be said to follow “good practice”; however, most aid flows through bilateral channels without meaningful government leadership; recently signs that military concerns are distorting some aid
Development Communication	-	--	Limited efforts and poor outcomes in development communication within Government, at political level, with civil society, with public, and by donors; expectations have been raised and not well-managed

Category	Policy/ Mgmt Score	Out- come Score	Comments
<b><i>Sector Policies and Performance</i></b>			
Education	0	+	Tremendous expansion of primary enrollment (including girls) but still a very long way to go; major quality issues at all levels of education
Health	++	+	Successful adoption of cost-effective Basic Package of Health Services, with expanding coverage; numerous problems in the hospital system
Roads	+	+	Rehabilitation of Afghanistan's highway system nearly complete, but often at high cost; much construction and repair of rural roads; concerns about meeting maintenance requirements
Telecoms	+	++	Major progress in mobile telecommunications based on competitive private sector with regulation
Irrigation, Water, and other Infrastructure	-	-	Some progress with rehabilitation e.g. in irrigation, but lack of major investments, very few credible feasibility studies, and in many cases weak progress toward sector strategies; enormous agenda for the future
Energy	-	--	Modest improvements in power supply, power master plan prepared; but limited progress in Kabul has been a source of popular discontent; institutional weaknesses, modest investments, sustainability concerns
Agriculture	--	-	Agricultural recovery from drought and some growth, but need transformation, agro-processing, and export development; weak institutions and need to bring in private business sector more
Community Development	+	++	National Solidarity Program now covers most villages and effectively delivers small-scale rural infrastructure; questions about the institutional dimension, sustainability, future roles of Community Development Councils
Social Protection	0	+	Significant relief efforts and public works employment programs, which have achieved moderate success; limited progress toward developing an effective, broad-based, and sustainable social protection strategy

*Note:* ++ = highly positive (very major progress); + = positive (substantial but uneven progress, remaining problems); 0 = neutral (neither positive nor negative, or mix of progress and setbacks); - = negative (on balance); -- = very negative (little or no progress or even backsliding).

*Source:* Author's assessments.

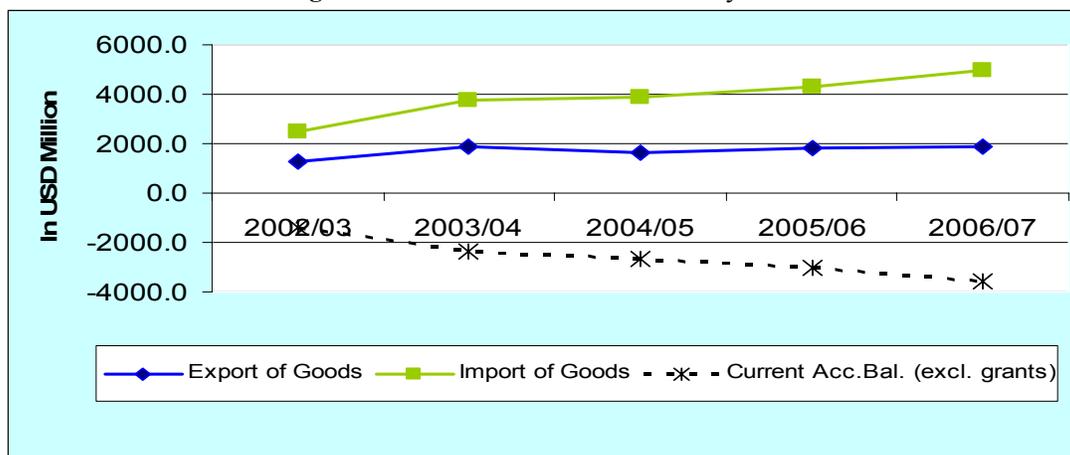
Afghanistan has also done well in resolving foreign debts and claims inherited from the conflict period and before. Arrears to international financial institutions (World Bank, Asian Development Bank, and IMF) were cleared through grants from bilateral donors in late 2002 and early 2003, paving the way for resumed lending. Bilateral claims on Afghanistan are being settled, most importantly large claims dating back to the former Soviet Union, through the Paris Club and Heavily Indebted Poor Countries (HIPC) Initiative. Afghanistan is expected to receive significant further debt relief through the HIPC Initiative and Multi-lateral Debt Relief Initiative (MDRI). The country maintains a prudent approach to incurring new foreign debt, limiting the amount and engaging in new borrowing only on concessional terms.

In other areas of economic policy the picture has been more mixed. Financial sector reforms—in particular the development of a sound regulatory framework—have encouraged a number of private banks to establish themselves in Kabul. However, there has been only limited progress in restructuring the half-dozen state-owned banks, most of which are financially unviable. Moreover, private businesses in Afghanistan still do not have much access to financial services, and access to finance constitutes one of the main perceived constraints on their activities (World Bank 2005c).

Turning to trade policy, Afghanistan has a liberal trade regime by regional standards, the result of a major tariff rationalization in 2004. But there are increasing pressures and lobbying by some businesses for a more protectionist approach, manifested in the recent imposition of a 40% tariff on imports of soft drinks and drinking water (well above the existing maximum tariff rate) and a provision for registered manufacturers to import industrial inputs at a special 1% tariff. Export performance falls far short of what is needed to progressively reduce the country's dependence on inflows of aid and drug proceeds. Trade facilitation is weak and trade administration suffers from red tape and corruption. Exports remain very

small in absolute terms while import growth has been rapid (Figure 4). The increasing current account deficit has been financed largely by aid.

**Figure 4: Trade and the Balance of Payments**



*Source: IMF estimates.*

Economic growth (excluding opium) has been high over the last five years (Figure 3), at double-digit rates on average. Rapid growth has helped facilitate progress on the whole range of reconstruction, political normalization, and development agendas. However, this growth spurt appears to reflect primarily factors that are one-time in nature (recovery after the end of major conflict and the severe drought of the late 1990s, from an extremely low base), temporary (influx of aid, population, remittances), or undesirable (stimulating impact of the opium economy). Moreover, Afghanistan's efforts to develop a pro-private sector and market-oriented policy environment have achieved only limited success, and a coherent, effective approach to sustaining economic growth, accompanied by effective deployment of the key required policy instruments, has not yet emerged (see World Bank 2005b). The economy remains dominated by the informal (including illicit) sector. The growth issue will become increasingly important in the future as the initial growth spurt diminishes and new, sustainable growth drivers will be needed. Another extremely important issue is employment, including concerns about unemployment of youth who have received elementary or high-school education (often of doubtful quality), as well as how to absorb the large numbers of rural inhabitants currently working in the opium economy (as farmers—mostly sharecroppers, and wage laborers).

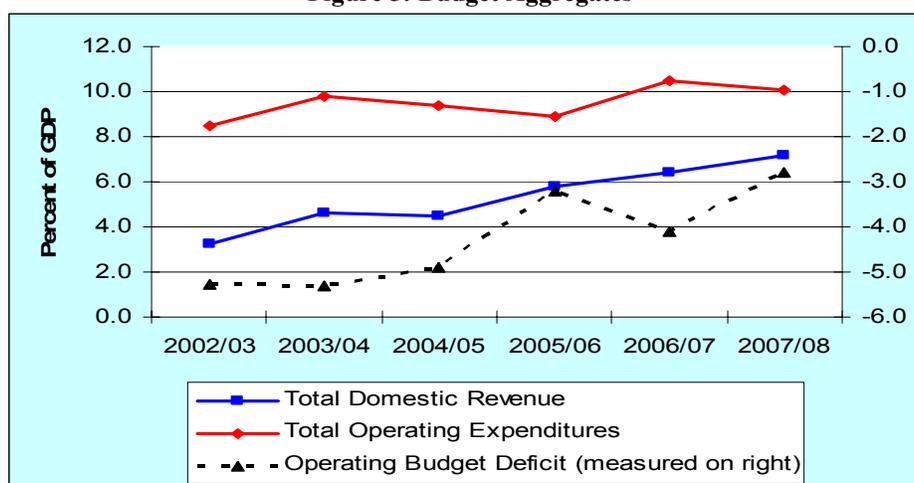
## **PUBLIC SECTOR MANAGEMENT AND GOVERNANCE**

By far the greatest progress in this area has been in public finance management (PFM). This encompasses improvements in broad fiscal aggregates as well as building better systems and processes to achieve positive outcomes. As can be seen in Figure 5, domestic revenue has been steadily increasing as a ratio to GDP, nearly doubling between 2002/03 and 2006/07. Operating expenditures are toward the lower end of the normal range for low-income countries. However, development expenditures include very substantial amounts of recurrent spending (see World Bank 2006a, Chapter 6). Substantial progress has been made in raising the proportion of operating costs paid by domestic revenues, and Afghanistan already can cover the government civilian payroll from its own revenues. Maintaining revenue growth and further progress toward a more sustainable fiscal position will require continuing strong efforts and political will.

While a sound budget process has been put in place (with a nine-month budget formulation cycle) and is functioning well for the operating budget, prioritization of the development budget has proven difficult. In recent years the aggregate core development budget target has far exceeded the out-turn of actual

spending, which reflects several factors: (i) weak sector planning and inclusion of many poorly prepared or unprepared projects in the budget; (ii) uncertainty and unpredictability of funding; (iii) difficulties in cutting the proposals of ministries even if based on past performance it is clear they are wildly excessive; and (iv) issues related to multi-year funding commitments and ensuring that budget allocations do not hinder spending on large or lumpy projects. As a result development budget allocations have not effectively prioritized spending; instead the *ex post* prioritization has depended on the pace of actual expenditures for different sectors and programs and therefore on the factors constraining implementation. There have however been large increases in the absolute level of development expenditures and some improvements in the ratio of actual spending to the development budget target. Nevertheless, prioritization continues to be a weak point in the budget process.

**Figure 5: Budget Aggregates**



Source: Ministry of Finance, Government of Afghanistan

Starting from an extremely low base, Afghanistan has made impressive improvements in the whole range of PFM systems and processes, from budget formulation to *ex post* accounting and auditing. An assessment of Afghanistan's PFM system based on the internationally-developed Public Expenditure and Financial Accountability (PEFA) indicators found that, by and large, Afghanistan had achieved levels comparable to other low-income developing countries: "This assessment generally portrays a public sector where financial resources are, by and large, being used for their intended purposes as authorized by a budget which is processed with transparency and has contributed to aggregate fiscal discipline. The expenditures and financial position of the Government are reported regularly in an understandable format. Performance regarding the allocation of spending across programs and agencies and the efficiency of operations is not as good, however." (World Bank 2006a: v).

Improvements in PFM represent a major accomplishment, especially considering the starting point in 2001. As noted, there continue to be weaknesses in prioritization and in enhancing efficiency of resource utilization. A general issue is that progress has been based to a large extent on external support to PFM operations. Hence the key challenge will be to maintain—and where possible further improve—PFM standards as external capacity is phased out over time and replaced by sustainable domestic capacity.

This leads into more general issues related to national capacity building and public administration reform (PAR), where performance has been considerably weaker than in PFM. Nevertheless significant progress has occurred, starting from a dire situation in which the Government was largely ineffective, and civil servants were paid only sporadically and at extremely low levels (due to hyperinflation in the 1990s), with the difference between pay of the lowest grades and top officials being only 10-20%—probably the

most compressed civil service pay structure in the world.<sup>7</sup> Payment of civil servants has been regularized, and virtually all civil servants are now paid, most of them in a timely manner. Significant albeit still very modest decompression of pay has occurred. However, the tendency in recent pay increases has been to raise the cash allowance across-the-board by the same amount for all staff, which does not increase pension liabilities. But this does set back efforts to further de-compress the salary structure.

The asymmetric Priority Reform and Restructuring (PRR) program was launched in 2004, under which key departments and in some cases ministries, in return for modest restructuring and merit-based recruitment for designated positions, could pay their staff at much higher salary scales on a temporary basis. The experience with PRR has been mixed. Initial results were good in some ministries and agencies, before an attempt at wholesale expansion of PRR (reflecting in part understandable political pressures and equity concerns) diluted quality—the restructuring in many cases was only *pro forma*, and merit-based selection for positions frequently was observed in the breach.

During the past two years the focus in PAR has shifted toward designing more comprehensive civil service reforms, including pay and grading reform which would raise and sharply decompress pay levels for civil service positions, with a vetting process to move existing civil servants onto the new pay structure based on their qualifications and explicit position requirements. This ambitious reform raises a number of questions, including about the fiscal cost and sustainability of the new pay structure; whether and to what extent organizational restructuring should precede the exercise (it makes little sense and would be very costly as well to move staff onto the new pay structure in departments that would ultimately be abolished or merged); how to ensure reasonably effective implementation (and avoid the risk of a wholesale rush to move everyone onto the new pay structure irrespective of qualifications or staffing needs); how to handle those civil servants who do not get moved to positions under the new pay structure; implications for pension costs; sequencing and timing of implementation, etc. Such reform efforts have more often than not failed in other developing countries. Nevertheless, the Government has moved ahead with the design of this program, and implementation is expected to start soon.

Capacity development remains a central issue that has not been well-addressed, except in a fragmented and unsustainable manner in some ministries. Much capacity has been “bought in” at high cost but has not resulted in building sustainable core capacity in Government. There are widespread concerns about the quality, cost, management, and capacity building impact of Technical Assistance (TA) in Afghanistan, which according to rough estimates amounts to several hundred million dollars per year (see Michailof 2007). Most TA is executed directly by the concerned donor, running the risk that it becomes overly supply-driven, uncoordinated, unguided by Government leadership, and limited in its impact—especially beyond the completion of individual TA assignments.

Despite these serious problems with PAR, by comparison other parts of the governance agenda have fared worse. Corruption by all accounts has increased greatly over the past five years and has spread widely. Anti-corruption efforts have been undermined by institutional disarray, apparently limited political commitment to take strong actions, and the sheer magnitude of the problem (including massive drug-financed corruption). The adverse impact of corruption is magnified in Afghanistan by (i) loss of the state’s capacity, effectiveness, and legitimacy during the conflict; (ii) entrenchment of an illicit/informal economy during the conflict—especially opium; (iii) the large amounts of funds available for corrupt purposes, including from drugs; (iv) pressures to spend aid money quickly at the expense of sound monitoring and financial controls; and (v) the fragility of the political situation and political normalization

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<sup>7</sup> The marked compression of pay in Afghanistan’s civil service reflected the severe erosion of base pay (which was reasonably differentiated) by hyperinflation, combined with across-the-board allowances to ameliorate the effect of inflation. This resulted in a situation where the bulk of pay was in the form of cash allowances which were the same for all civil servants. See Evans *et al* (2004) for a discussion of pay and other conditions in the Afghan civil service.

process. The Government has consistently emphasized its commitment to fight against corruption, and there have been promising initiatives and progress in some areas. Examples include:

- The prominence given to the anti-corruption agenda in Government public statements and documents, starting from 2002 and continuing.
- Substantial progress in developing and implementing basic fiduciary controls to limit the risk of corruption in Afghanistan's Core Budget, and more generally improvements in PFM which play an important role in preventing corruption.
- Assessments of vulnerabilities to corruption (VCAs) which are underway in a number of sectors/areas. Examples include revenue administration, the civil service appointment process, energy, roads, underground resources, and others.
- An anti-corruption roadmap paper prepared with assistance of international partners, and work by a high-level Inter-Institutional Committee to identify sources of corruption and propose remedies.

Nevertheless, these areas of progress pale against the magnitude of the challenge. If nothing is done about corruption, Afghanistan's development prospects will be severely threatened and undermined. This is not only due to the associated direct losses of resources and the adverse effects of distorted behavior, but also because corruption attacks the legitimacy of the government—vis-à-vis both the Afghan people whose buy-in and support is essential, and the international community which is providing financial and military assistance as well as political backing. Corruption is profoundly inimical to state-building, a core element of the overall reconstruction and development agenda.

Counter-narcotics efforts have not succeeded in reducing opium production which has soared to record levels, and moreover they have inadvertently contributed to a consolidation of the drug industry around fewer, powerful, and politically connected actors (Buddenberg and Byrd 2006). Opium poppy cultivation has increased sharply since 2001; it has shifted around the country, first spreading to most provinces and then becoming more concentrated in the insecure, insurgency-ridden province of Helmand; it has shifted over time, with local or national success in reducing output turning out to be unsustainable; and the drug trade has become more organized and consolidated, as noted above.

Security sector reform has been a problem area despite successes. The Afghan National Army has been established and is being expanded, and the Disarmament, Demobilization, and Reintegration (DDR) process was completed for more than 60,000 "official" militia forces. However, numerous illegal armed groups remain, and progress in disbanding them has been slow. Reforms in the national police have not made much headway (Wilder 2007). Afghanistan still lacks a comprehensive national security strategy which brings together, reconciles, and prioritizes the disparate objectives of different stakeholders. A particular concern is the cost and fiscal sustainability of decisions about and investments in the security sector (World Bank 2005a, Volume V).

The justice sector is key to rule of law and security, but reforms and investments in the justice sector have lagged far behind improvements in security services (especially the Afghan National Army), as discussed in World Bank (2005a, Volume V). This imbalance reflects weak and fragmented Government leadership and ineffective donor support. Lagging justice sector reform has adverse ramifications for other important parts of Afghanistan's overall development agenda, including private sector development. This gap has been increasingly recognized by all stakeholders, and a major international meeting held in Rome in July 2007 was intended to spotlight justice sector reform.

## **DEVELOPMENT MANAGEMENT AND AID COORDINATION**

Afghanistan has not lacked for high-quality development strategy documents, including the draft National Development Framework in April 2002 (Afghanistan Government 2002), the *Securing Afghanistan's*

*Future* report which came out in January 2004 (see Afghanistan Government and International Agencies 2004), and the Interim Afghanistan National Development Strategy (I-ANDS) produced in early 2006 (Afghanistan Government 2006). In addition, although the Bonn Agreement of December 2001 did not deal extensively with development issues, the Afghanistan Compact agreed with the international community in January 2006 includes major clauses and a number of benchmarks covering development aspects. Numerous strategy documents have also been prepared on individual sectors and topics. The Government is currently working on an ambitious full-scale ANDS, which will serve as Afghanistan's Poverty Reduction Strategy Paper to be submitted to the World Bank and International Monetary Fund.

Two issues have adversely affected development strategy formulation however. First, there was extremely limited consultation and dissemination around the earlier strategy documents. The National Development Framework was never translated into national languages and was little disseminated outside donor meetings. *Securing Afghanistan's Future* did not have full buy-in within the Government and did not include a significant consultation component. Although there were more extensive consultations around the I-ANDS, neither it nor the Afghanistan Compact were presented to or discussed in Parliament, even though the latter committed the Government to certain benchmarks requiring Parliamentary ratification.

Second, these strategy documents tended to reflect a "needs assessment" approach and did not embody a resource envelope (except as constructed *ex post* by adding up the requirements), nor explicit prioritization and sequencing or even some principles to guide prioritization.<sup>8</sup> A needs assessment approach was less problematic in the early years when absorptive capacity was more limited, the budget process was rudimentary, and available funds could not be fully spent. *De facto* prioritization was determined under such conditions by the disbursement rates for spending on different activities. Beyond a certain point however (certainly reached in the last several years), both improvements in the budget process and increasing absorptive capacity meant that meaningful prioritization has become much more necessary, and hence the lack of prioritization in Government strategy documents is now a more serious disconnect and constraint. This lacuna has been recognized, and the full ANDS is intended to include a much greater focus on costing and prioritization. However, as prioritization is fundamentally a political process, and given the nascent politics currently in Afghanistan—within the Cabinet as well as *vis-à-vis* the Legislature, effective prioritization both for the development strategy and in the annual budget process will be a difficult challenge and will take time to instill.

Turning to Government leadership, the Government has attempted with some degree of success to take leadership of the development agenda and development management (including aid management). By the end of 2002 a donor-driven and donor-led mechanism—the Afghanistan Reconstruction Steering Group—had been replaced by a Government-led Consultative Group process. Subsequently the Government has demonstrated a considerable degree of leadership in these areas, including through regular annual Afghanistan Development Forum meetings and frequent Consultative Group meetings, organizing and taking the lead on major development strategy exercises, and also strongly emphasizing key elements of the aid effectiveness agenda. However, Government leadership has run into limits and has fallen well short of what would be desirable. This relates in part to political issues, manifested in fragmentation and lack of coordination across the Government in development management and economic policymaking. Even the Government's more successful policies and programs often have lacked strong government-wide buy-in, undermining their sustainability. Leadership and management capacity also are a constraint in many line ministries, as discussed later.

The difficulties in exercising Government leadership also reflect inherent tensions stemming from Afghanistan's extraordinarily high dependence on aid and the modalities of aid delivery. Fundamentally there is a contradiction between government leadership and high aid dependence—the "State Building

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<sup>8</sup> See World Bank (2006a, Chapter 5) for a discussion of approaches to prioritization at different levels.

Paradox” referred to in Nixon (2007), which needs to be well-managed to avoid prolonged aid dependence detracting from government leadership. As discussed in Guimbert (2007), institutional development takes a long time under any circumstances, particularly those faced by Afghanistan, and there are serious pitfalls related to aid dependence and capacity limits.

Difficulties in aid management and coordination have been exacerbated by the following factors. First, an enormous number of donors are active in Afghanistan—according to the Government as many as 62 including non-governmental donors. Second, a number of these donors—on the order of a half-dozen or more—are major players in terms of the amount of assistance they provide and/or as actors on the world stage. There is, unlike in many other post-conflict countries, no natural dominant or “lead” donor (e.g. for reasons of geographical proximity) in the development sphere, although the US plays such a role on the military side.<sup>9</sup> In addition the UN system, and the United Nations Assistance Mission in Afghanistan (UNAMA) in particular, plays a very important role, led by a Special Representative of the UN Secretary-General. This includes overall coordination of the closely inter-linked political, security, and development agendas.

While in part a reflection of the high degree of aid dependence and very limited capacity in Government, problems in aid management also relate very much to the modalities of aid provided to Afghanistan. Roughly two-thirds of total assistance to Afghanistan (more in the early days) has been channeled bilaterally outside the Government budget and control systems, with little coordination and even limited information-sharing. Although some donors provide most of their aid through the Afghan national budget, several very large donors go off-budget with the bulk of their assistance.

The deleterious effect of this pattern of aid flows on state building more generally, as well as on efforts by the Government to take leadership in development management, must be emphasized. While in other developing countries much if not most aid also tends to be off-budget, the damaging effects are more limited in situations where the Government usually has enough domestic revenue to cover most of its recurrent budget expenditures and often part of development spending as well. In Afghanistan, on the contrary, a “business-as-usual” approach to aid can be much more damaging. In addition to the serious difficulties such a pattern of aid poses for Government leadership, it can be highly distortionary in terms of prioritization, lack of predictability, and also competition in the Afghanistan context for very scarce qualified human resources which get bid away by foreign agencies and off-budget projects from working in the Government. Much of Afghanistan’s very limited pool of professional and managerial talent is employed in this “second civil service” (see World Bank 2005b, Chapter 4), and widespread use of “top-ups” paid by donors undermines civil service management and reforms as well as more generally Government leadership.

The Paris Declaration on Aid Effectiveness, subscribed to in March 2005 by most donors and developing countries, provides a framework to assess the workings of the aid community in any country, including Afghanistan. Although the Paris Declaration did not exist during the first several years of Afghanistan’s reconstruction, it embodies elements of good practice that have become increasingly well-known and accepted (based on the lessons from decades of global development efforts), some of which were already being applied in Afghanistan. The Government has fully taken on board the Paris Declaration, and is using its indicators as guideposts for improving aid effectiveness. These indicators include ownership and

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<sup>9</sup> The USA is by a large margin the biggest aid donor to Afghanistan. However, the European Commission, Japan, the UK, and several other European countries also are major donors to Afghanistan. The World Bank and Asian Development Bank both provide several hundred million dollars per year in support of Afghanistan’s reconstruction and are the largest contributors to Afghanistan’s core budget, followed by the main donors to the ARTF, led by the UK and including (in varying order of cumulative total paid-in contributions depending on the date of comparison) Canada, the European Commission, the Netherlands, and the USA. For many smaller donors, Afghanistan is their most important aid recipient or among the most important. Some smaller development donors contribute significant numbers of troops in Afghanistan adding further complexity to the situation.

managing for results (primarily the responsibility of the host government), alignment and harmonization (primarily the responsibility of donors), and mutual accountability (a joint responsibility of government and donors). In the case of alignment, there are 10 sub-indicators, of which one (reliable country systems) is primarily the host government's responsibility. Ownership and mutual accountability each consist of a single indicator, whereas harmonization includes two sub-indicators.

### **Box 1 : Paris Declaration Indicators—Summary Status in Afghanistan**

#### **OWNERSHIP**

**1. National development strategy with clear priorities linked to a medium-term expenditure framework and reflected in annual budgets.** The Government has prepared important strategy documents which have laid out national objectives and broad approaches for different sectors and development issues. It has also, starting in 2005, prepared a Medium-term Fiscal Framework (MTFF) with projections of fiscal aggregates and main expenditure components. However, there are weaknesses in prioritization, and there is a need as the full ANDS is prepared to put forward strategic priorities and to link these priorities with the MTFF and annual budget.

#### **ALIGNMENT**

**2. Reliable country systems (procurement and financial management).** Afghanistan has made good progress in establishing some reliable country systems. A credible budget process has been put in place and progressively improved, and financial management processes and controls are functioning. A new procurement law has been promulgated and regulations have been prepared, although much needs to be done to develop adequate capacity in the Government to conduct procurement transactions.

**3. Aid flows aligned on national priorities.** Most aid has not been channeled through the national budget and therefore suffers from lack of alignment. Aid that is on-budget is well aligned, but is affected by weak prioritization on the part of the Government in the case of the development budget.

**4. Coordinated support to strengthen capacity.** Technical assistance has been by most accounts inefficient, wasteful, and poorly aligned with national requirements and sustainable capacity-building.

**5a. Use of country financial management systems.** Use of Afghanistan's public financial management systems occurs for the minority of aid that flows through Government budget channels, but not for most aid.

**5b. Use of country procurement systems.** Same as for Indicator 5a, although it must be recognized that Government capacity to fully implement the new procurement law is still quite limited; a number of donors have stated that they are willing to use national procurement procedures when the capacity exists.

**6. Avoiding parallel implementation structures (parallel PIUs).** For aid flowing outside national budget channels, donors often set up implementation supervision arrangements that are not part of the Government, whereas there tend not to be isolated, parallel (to Government agencies) PIUs for aid that is channeled through the national budget.

**7. More predictable aid.** There has been reasonable progress in this regard for the minority of aid that is channeled through the national budget. The ARTF, in particular, provides predictable support to Afghanistan's operating budget. Off-budget aid on the whole tends to remain less predictable for a variety of reasons, although there is variation across donors.

**8. Untied aid.** With the exception of ARTF contributions which by their nature are untied, bilateral donors' practices in this regard vary considerably and correspond to their global practices on tied versus untied aid.

#### **HARMONIZATION**

**9. Use of common, program-based approaches.** Considerable amounts of aid have been provided to support government-led national programs, but most aid has been channeled through discrete projects not organically part of national programs, or, if there was a programmatic element, it was often donor-driven and not part of a government-led national program. It should be recognized however that harmonization by donors around largely donor-led programs can achieve some positive benefits; rehabilitation of the highway network is an example.

**10. Encourage shared analysis.** There has also been progress on shared analysis and work. Donors have worked together in cooperating on key analytical work and also often in terms of joint missions. Coalescence of donors around joint analytical work has been facilitated when there was a clear lead from the government; the *Securing Afghanistan's Future* exercise in 2003/04 is a notable example.

#### **MANAGING FOR RESULTS**

**11. Transparent and monitorable performance assessment frameworks.** Transparent and monitorable performance assessment frameworks have been developed in some sectors (e.g. Health). The program budgeting initiative, started in three ministries and currently being expanded, includes results frameworks for the sectors/programs concerned. The challenge in the future will be to develop an operational and useful performance assessment framework for the ANDS as a whole.

#### **MUTUAL ACCOUNTABILITY**

**12. Mutual assessments of progress in implementing agreed commitments on aid effectiveness.** This broadly speaking is an important principle of the Afghanistan Compact: both Government and donors are accountable for pursuing the objectives and achieving the benchmarks of the Compact. More narrowly, in the Paris Declaration context, mutual accountability refers to conducting mutual assessments of progress in implementing agreed commitments on aid effectiveness. The Government is taking the lead in monitoring progress in this regard, and many donors are fully supportive.

*Note: Some indicators are paraphrased and hence the wording may not be identical to that found in the Paris Declaration.*

*Source: Organization for Economic Co-operation and Development (2005); author's assessments.*

Box 1 (above) briefly summarizes Afghanistan's status with respect to each of the Paris Declaration indicators. Overall, there has been significant progress with respect to indicators where the Government is primarily responsible, although still a long way to go. As noted earlier, the Government has prepared a

number of high-quality strategy documents and a Medium-term Fiscal Framework is in place, but much work will be required to ensure that the ANDS is prioritized, consistent with the MTF, and increasingly integrated with the annual budget over time. Reliable public financial management systems are in place but further improvements are needed, and improvements in procurement based on a new legal framework are getting underway. The general pattern with respect to alignment and harmonization is that the minority of aid funds that are channeled through Afghanistan's national budget are at least broadly in line with Paris Declaration indicators, whereas most off-budget aid understandably tends to be much less aligned and harmonized. Thus a way forward in implementing the Paris Declaration in the case of Afghanistan is to increase the proportion of aid channeled through the national budget, while further improving Government systems and strengthening the Government's strategic ownership and leadership to help facilitate this continuing progressive shift.

With respect to mutual accountability, in 2006 the international community and the Government of Afghanistan subscribed to a comprehensive Afghanistan Compact with five-year benchmarks, and associated with it are a monitoring and dialogue process overseen by a Joint Coordination and Monitoring Board (JCMB) co-chaired by the Government and UN. This process is intended to operationalize meaningful accountability and represents a serious attempt in that regard. Despite undoubted benefits, this process appears to be rather burdensome (not least in terms of the number of meetings) and mechanically process-oriented, although there have been some improvements more recently. There is no sign that the JCMB process can offset the deficiencies related to off-budget aid discussed above. The Government is also making a serious attempt (led by the Ministry of Finance) to monitor progress in implementation of the Paris Declaration, as part of an international effort in this regard.

Finally, and not directly reflected in the Paris Declaration indicators, development communication—both within the Government and especially with the full range of national stakeholders—is another problem area. Positive messages about progress have not been emphasized strongly enough, nor repeated often enough to have a commensurate impact on perceptions. Inflated expectations have been exacerbated by high-profile meetings, numerous high-level visits, and public announcements of large amounts of assistance available or pledged. This area has not received sufficient priority from either Government or donors, and there has been fragmentation in communications, with little coordination for the most part. As a result, not only have positive benefits been limited, but disappointed expectations among the populace are increasing.

## **SECTOR POLICIES AND PERFORMANCE**

At the sector level, development performance not surprisingly has varied (Table 1). Great progress has been achieved in Health (through implementation of the Basic Package of Health Services, BPHS, mainly by non-government providers), and in community-based small-scale rural infrastructure development through the National Solidarity Program (NSP). Extraordinary success has been achieved in expanding mobile telecommunications through competitive private sector development with regulation; tele-connectivity in Afghanistan increased from an estimated two per 1,000 population in 2000 to around 140 in 2007. Rehabilitation and construction of roads has achieved significant progress albeit often at relatively high unit costs (see World Bank, 2005a, Volume IV, Chapter 5). But progress has been poor in the energy sector and also in most other infrastructure. Considerable social protection has been provided through humanitarian assistance, but without a strong strategy or effective Government programs. Education has seen tremendous increases in access and enrollments, with elementary school enrollments (including most impressively for girls) reaching unprecedented levels far above any seen in the pre-war period. However, there are serious concerns about the quality of education at all levels. And education is being delivered predominantly through the traditional highly centralized service delivery model, with teachers having the status of civil servants in the national government, which raises a number of questions on fiscal, accountability, and efficiency grounds.

Although different models of the role of the state and service delivery have been used in the various sectors, the most important determinant of performance appears to have been the strength and cohesion of Afghan leadership in line ministries. Ministries which, led by the minister himself or herself or a competent, cohesive, empowered leadership team below the minister level, have developed and implemented a sound approach to the sector, have achieved considerable progress. On the other hand, ministries lacking leadership and a cohesive management team at the top have struggled and have achieved much less if any progress. It is also clear from experience that Afghan leadership has been a dominant factor as compared with the *ex ante* quality, orientation, and amount of donor technical and financial assistance to a sector. In successful sectors and line ministries, donor support also looks like it played a very positive role *ex post* (and actually did so), but this relationship does not hold *ex ante*. Thus the impact of external assistance depends very much on the quality of Afghan line ministry leadership.<sup>10</sup>

This suggests that with leadership improvements, the performance of lagging line ministries could be raised closer to the level of better-performing ministries, with a strong positive impact on sectoral and overall development performance. Lagging line ministries' Afghan leadership teams would need to be strengthened and made more coherent. This would certainly be possible in terms of the Afghan human capacity available for such positions, and indeed, there have been leadership improvements in some ministries characterized by weak performance in the past. However, the selection of Cabinet members is affected by political constraints, and if changes are focused on the level immediately below the minister, issues related to empowering competent ministry management teams would need to be addressed.

## **OVERALL ASSESSMENT AND INTERNATIONAL COMPARISON**

Overall, this assessment of development policies and performance, based on a composite picture of the last 5-6 years, is reasonably positive. Stepping back from day-to-day engagement, and thinking about the picture in relation to the starting point, it is clear that despite enormous challenges and constraints, meaningful progress has been made. The situation after six years would have been much worse, if not for the currency reform and macroeconomic stability; rapid economic growth and associated rises in incomes; payment of civil servants' salaries on an increasingly regularized basis; expansion of service delivery in some sectors (health, education); and a successful community development program (NSP). In many other areas progress has been less dramatic but nevertheless significant in many respects.

There are, however, areas where progress has been limited or lacking. In economic management, the broader enabling environment for private business in the formal sector is still quite weak. There are very serious problems with the governance agenda (other than PFM), including uneven progress in public administration reform, stumbling justice sector reforms, widespread and by all accounts increasing corruption, and counter-narcotics efforts which have failed to stem a large increase in opium production and have inadvertently contributed to consolidation of the drug industry. On the development management front, despite considerable progress there are serious problems: the aid system remains to a large extent fragmented and chaotic, most aid goes outside government channels, and efforts by the Government to exert leadership have run into limits. At the sector level, there has been poor progress in major infrastructure development (other than telecommunications and highways). Lack of electricity, water, and other essential services in many urban areas is not only a serious development issue but also gives rise to discontent. More fundamentally, the lack of security in many parts of the country, and limited rule of law, are critical issues.

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<sup>10</sup> It should also be noted that in the absence of adequate line ministry leadership, Technical Assistance (TA) including especially external consultants can aggravate rather than ameliorate problems. Multiple, uncoordinated, competing TA providers, different policy views, advisors reflecting the views of donors funding them as much as or more than Government interests, low quality and supply-driven nature of TA—all of these problems easily can become unmanageable in the absence of effective line ministry leadership. See Michailof (2007) for an assessment of TA and capacity building.

Turning to development outcomes, these have been driven in the positive sense by rapid economic growth over the past five years and increasingly effective programs and service delivery in a few sectors. However, even after a substantial rise Afghanistan's per-capita income remains very low, and its social indicators are still among the worst in the world despite improvements in some of them. Employment in the formal sector, like formal-sector development as a whole, has not made much of a dent in the growing labor supply, and although the informal sector mops up unemployment, it most probably includes much low-wage underemployment and seasonal employment. Finally, poverty reduction is the ultimate development outcome, and the revival of economic activity and growth undoubtedly has had a positive impact in this regard. But poverty remains widespread and deep.

Afghanistan's current situation in terms of its institutions and policies for development can be evaluated on an internationally comparable basis using the World Bank's Country Policy and Institutional Assessment (CPIA) methodology. The CPIA, representing the assessments of Bank country teams based on specified criteria and with checks to ensure cross-country and cross-region comparability, is not very precise but provides useful indications of where a country stands internationally, both overall and for the major categories of the CPIA: Economic Management, Structural Policies, Policies for Social Inclusion / Equity, and Public Sector Management and Institutions.

Afghanistan first participated in the CPIA process in 2006, and its ratings are now routinely published along with those of other countries eligible for assistance from the International Development Association (IDA). Table 3 shows the 2006 CPIA overall ratings and those for main categories as well as sixteen specific sub-categories, for selected countries including Afghanistan. Overall, Afghanistan with a composite rating of 2.6 (on an ascending scale of 1 to 6) ranks 69<sup>th</sup> out of the 77 countries for which CPIA ratings are made public, well below other South Asian countries and in the same neighborhood as a number of low-income African countries affected by or recovering from conflict. Among non-African countries, Afghanistan ranks slightly below East Timor and somewhat further below Haiti, Uzbekistan, and Laos. Relatively good ratings for Afghanistan in economic management, trade policy, building human resources, and quality of budget and public financial management are offset by low ratings for most dimensions of social inclusiveness/equity (including gender equality) and public sector management and institutions (especially property rights and rule-based governance). The CPIA ratings indicate that despite considerable progress from an extremely low starting-point in late 2001, Afghanistan still lies close to the bottom globally in terms of the CPIA as well as economic and social indicators.

## **SOME CAVEATS**

In addition to uneven progress across different parts of the development agenda, there are a number of important caveats affecting this assessment as a whole or parts of it, which must be taken into account and generally temper the level of optimism. First, progress has been assessed against the starting point in late 2001. While this is undoubtedly useful, what is most relevant for Afghanistan's future prospects is whether progress has been adequate in relation to what the country needs to escape from the "conflict trap" of the 1990s and move forward on the path of sustained development. Although much more difficult to evaluate against this criterion, progress in many areas clearly has not met such a more demanding standard.<sup>11</sup>

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<sup>11</sup> Afghanistan's CPIA ratings, discussed above and shown in Table 3, provide an indication of where shortfalls may be greatest, but do not address the question of what levels of effort, progress, and outcomes would be sufficient for the country to achieve sustained development.

**Table 3: Country Policy and Institutional Assessment (CPIA) Ratings for Selected Countries, 2006**

Rank	Country	A. Economic Management					B. Structural Policies					C. Policies for Social Inclusion/Equity					D. Public Sector Management and Institutions					IDA Resource Allocation Index (RAI)
		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	Ave.				
		Macro. Mgt.	Fiscal Policy	Debt Policy	Ave.	Trade	Financial Sector	Business Regulatory Environ.	Ave.	Gender Equality	Equity of Public Resource Use	Building Human Resour.	Social Protection & Labor	Pol. & Instit. for Environ. Sustain.	Ave.	Property Rights & Rule-based Govern.	Quality of Budget & Financ. Mgt.	Effic. of Revenue Mobil.	Quality of Public Admin.	Transpar., Account. & Corrupt. Pub. Sec.	Ave.	
8	UGANDA	4.5	4.5	4.5	4.5	4.0	3.5	4.0	3.8	3.5	4.0	3.5	4.0	3.9	3.5	4.0	4.0	3.0	3.0	3.0	3.3	3.9
10	VIETNAM	5.5	4.5	4.0	4.7	3.5	3.0	3.5	3.3	4.5	4.5	4.0	3.0	3.5	3.9	3.5	4.0	3.5	3.5	3.0	3.5	3.9
13	INDIA	4.5	3.5	4.5	4.2	3.5	4.0	3.5	3.7	3.5	4.0	4.0	3.5	3.7	3.5	4.0	4.0	4.0	3.5	3.5	3.7	3.8
22	INDONESIA	4.5	4.0	4.5	4.3	4.5	3.5	3.0	3.7	3.5	4.0	3.5	3.5	3.0	3.5	2.5	3.5	3.5	3.5	3.0	3.2	3.7
25	KENYA	4.5	4.0	4.0	4.2	4.0	3.5	4.0	3.8	3.0	3.5	3.5	3.0	3.0	3.2	3.0	3.5	4.0	3.5	3.0	3.4	3.7
28	PAKISTAN	4.0	3.5	4.5	4.0	4.0	4.5	4.0	4.2	2.0	3.5	3.5	3.0	3.5	3.1	3.0	3.5	3.5	3.5	2.5	3.2	3.6
33	SRI LANKA	3.0	3.0	3.5	3.2	3.5	4.0	4.0	3.8	4.0	3.5	4.0	3.5	3.5	3.7	3.5	4.0	3.5	3.0	3.5	3.5	3.6
36	BANGLADESH	4.0	3.5	4.5	4.0	3.5	3.0	3.5	3.3	4.0	3.5	4.0	3.5	3.0	3.6	2.5	3.0	3.0	3.0	2.5	2.8	3.4
37	NEPAL	4.5	3.5	3.5	3.8	4.0	3.0	3.0	3.3	3.5	3.5	3.5	3.0	3.0	3.3	3.0	3.5	3.5	3.0	3.0	3.0	3.4
43	TAJKIKISTAN	4.5	4.0	4.0	4.2	4.0	3.0	3.5	3.5	3.5	3.0	3.0	3.5	2.5	3.1	2.5	3.0	3.0	2.5	2.0	2.6	3.3
47	NIGERIA	4.0	4.0	4.0	4.0	3.0	3.0	3.0	3.0	3.0	3.5	3.0	3.0	3.0	3.1	2.5	3.0	3.0	2.5	3.0	2.8	3.2
49	CAMBODIA	4.0	3.0	3.5	3.5	3.5	2.5	3.5	3.2	4.0	3.0	3.5	3.0	3.0	3.3	2.5	3.0	3.0	2.5	2.5	2.7	3.2
52	SIERRA LEONE	4.0	3.5	3.5	3.7	3.5	3.0	2.5	3.0	3.0	3.0	3.0	3.0	2.0	2.8	2.5	3.5	3.0	3.0	2.5	2.9	3.1
54	LAO, PDR	4.0	3.5	3.5	3.7	3.5	2.0	3.0	2.8	3.5	3.5	3.0	2.0	3.5	3.1	3.0	3.0	2.5	3.0	2.0	2.7	3.1
57	UZBEKISTAN	3.0	3.5	4.0	3.5	2.5	2.5	2.5	2.5	2.5	3.5	4.0	3.5	3.5	3.6	2.0	3.0	3.0	2.5	1.5	2.4	3.0
62	HAITI	3.5	3.5	2.5	3.2	4.0	3.0	2.5	3.2	4.0	3.0	2.5	2.5	2.5	2.7	2.0	3.0	2.5	2.5	2.0	2.4	2.9
63	CONGO, DEM. REP.	3.5	3.5	2.5	3.2	4.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	2.5	2.9	2.0	2.5	2.5	2.5	2.0	2.3	2.8
67	TIMOR-LESTE	2.5	3.0	3.5	3.0	3.5	2.5	1.5	2.5	3.0	3.0	2.5	2.5	2.0	2.6	1.5	3.0	3.0	2.5	3.0	2.6	2.7
68	ANGOLA	3.0	3.0	2.0	2.7	4.0	2.5	2.0	2.8	3.0	2.5	2.5	2.5	3.0	2.7	2.0	2.5	2.5	2.5	2.5	2.4	2.7
69	AFGHANISTAN	4.0	3.0	3.0	3.3	3.0	2.0	2.5	2.5	2.0	2.5	3.0	2.0	2.0	2.3	1.5	3.0	2.5	2.0	2.5	2.3	2.6
70	GUINEA-BISSAU	2.0	2.5	1.5	2.0	4.0	3.0	2.5	3.2	2.5	3.0	2.5	2.5	2.6	2.6	2.5	2.5	3.0	2.5	2.5	2.6	2.6
71	SUDAN	3.5	3.0	1.5	2.7	2.5	3.0	3.0	2.8	2.0	2.5	2.5	2.0	2.3	2.0	2.0	2.0	3.0	2.5	2.0	2.3	2.5
73	ERITREA	2.0	2.0	2.5	2.2	1.5	2.0	2.0	1.8	3.5	3.0	3.5	3.0	2.0	3.0	2.5	2.5	3.5	3.0	2.5	2.8	2.5
75	CENTRAL AFR. REP.	3.0	3.0	1.5	2.5	3.5	2.5	2.0	2.7	2.5	2.0	2.0	2.0	2.2	2.0	2.0	2.0	2.5	2.0	2.5	2.2	2.4
77	ZIMBABWE	1.0	1.0	1.0	1.0	2.0	2.5	2.0	2.2	2.5	1.5	2.0	1.5	2.0	1.0	1.0	2.0	3.5	2.0	1.0	1.9	1.8

Note: For calculation of the cluster averages, all criteria are equally weighted within a cluster; overall IRAI is calculated as the mean of the score of four clusters.

Scale: 1 = Lowest, 6 = Highest.

Source: World Bank International Development Agency (IDA) Resource Allocation Index (RAI), based on Country Policy and Institutional Assessments (CPIAs) for the individual countries. For a complete list of the ratings of IDA-eligible countries ratings and also the criteria by which ratings are determined, see:

<http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/IDA/0,,contentMDK:21359477~menuPK:2626968~pagePK:51236175~piPK:437394~theSitePK:73154,00.html>

A second, related caveat is that the progress and accomplishments, however real, are running far behind expectations—on the part of the population, politicians, donors, and government officials. Expectations were unrealistically high at the outset, but they were further fueled by numerous and often high-level donor meetings, politicians’ promises (by both Afghans and international actors), large pledges and commitments of aid announced with much fanfare, smaller but nevertheless very substantial amounts of aid funds reported as disbursed, and comparison with the reality that public services, infrastructure, and basic government functioning are still in a poor state in many respects and in much of the country. This clash of expectations with reality is not only a problem in itself, but it also adversely affects Afghanistan’s prospects through the popular discontent fueled, which can have political and at the extreme even security implications. In addition to inherent problems of managing expectations in such a volatile environment where expectations understandably were high after a quarter-century of conflict, as discussed earlier this problem is also attributable to weak development communications.

A third important caveat is that a composite picture of the last 5-6 years does not do justice to changing trends and dynamic developments (discussed later). Recent trends may diverge from earlier progress. There are important examples where progress during the first 2-3 years was followed by slowdown, drift, or backsliding—adversely affecting future prospects. In the economic sphere such a pattern has been limited to a few areas, most notably trade policy. In public sector management and governance, corruption may have worsened more rapidly in recent years than at the beginning, and clearly the role of the drug industry and its interactions with the state have evolved in a problematic direction. The role of Parliament (including in the budget process) is still relatively new and continues to develop. On the other hand, in the justice sector recent improvements in leadership may open up opportunities for reform that did not exist earlier.

A fourth issue relates to “windows of opportunity” that may arise (including in the immediate post-conflict period), which are best exploited while they are open. This issue is discussed in more detail later. The timing and length of windows of opportunity vary for different elements of the development agenda. Success in exploiting windows of opportunity also has varied. A key point is that while understandable and maybe effective in some contexts and for pursuing certain objectives, a “satisficing” or “minimum effort” approach carries grave risks in a situation where there are windows of opportunity. Moreover, during the “window”, progress may appear good even without too much effort, whereas this is not sustainable and as the time passes and the window of opportunity narrows or closes, the same level of effort will no longer prove adequate.

A fifth caveat is that irrespective of progress in areas covered by this paper, other problems are impinging on Afghanistan’s development prospects. The broad elements of the country’s overall agenda are closely inter-linked. The insurgency in the south and east poses serious threats. A second set of issues relates to the politics. Even though the political benchmarks of the Bonn process were met and all of the institutions of a democracy are now in place at least in rudimentary form, political normalization in an environment characterized by lack of rule of law, entrenched power-holders from the protracted conflict situation, weak norms of democratic political behavior, and the insurgency can be problematic. Although it is too early to assess these trends, there are grounds for concern.

With these caveats, the undoubted achievements of the past half-dozen years are more realistically set against the magnitude of the challenges and apparent drift and backsliding in some areas. In this context, the question of where more needs to be done and where efforts should be prioritized comes to the fore—this is taken up in the final sections.



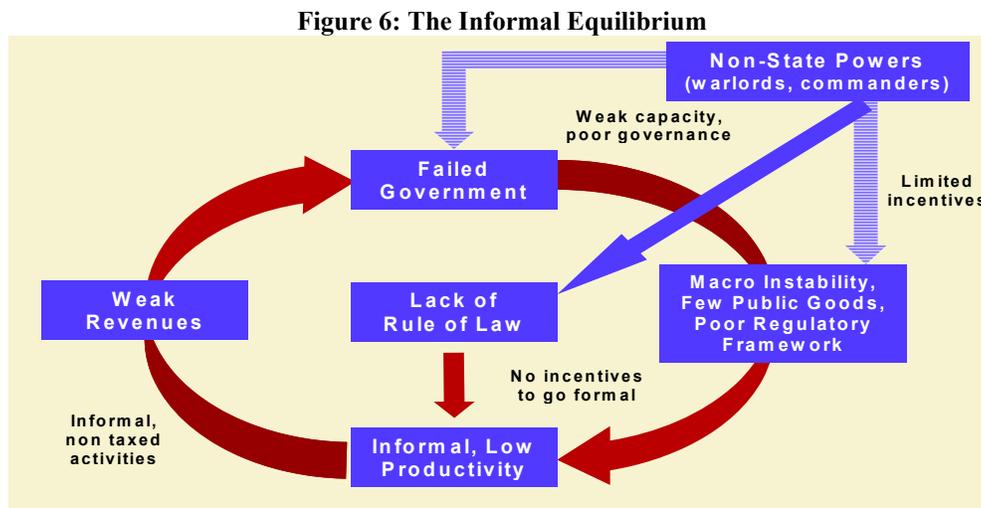
### III. DYNAMICS AND WINDOWS OF OPPORTUNITY

This section delves into the changing dynamics of Afghanistan’s state building agenda and inter-linkages with other key dimensions. It also focuses on the evolution of the drug industry, and then explores various “windows of opportunity” since 2001, their timing, and to what extent they have been exploited.

#### CHANGING DYNAMICS: STATE BUILDING, FORMALIZATION, AND SECURITY

The need for strategic integration of the different elements of Afghanistan’s development agenda—security, reconstruction, economic growth, governance, state building, counter-narcotics—has been widely recognized.<sup>12</sup> The conceptual framework of a “vicious circle” or low-level “informal equilibrium” was used in World Bank (2005b, Chapter 1) to analyze the forces at work during the conflict and immediately post-2001, which mutually reinforced each other and contributed to keeping Afghanistan poor, dominated by the informal sector, weakly governed, lacking rule of law, and subject to chronic insecurity. Developments since 2001 have brought major changes to the scene, but the underlying structure and dynamics remain very important.

This informal equilibrium is depicted in Figure 6. Since the failed state could not ensure security around the country, local powers (warlords) took over this role, but they undermined rule of law and had limited incentives to provide public goods. Instead they often developed profitable illegal activities to pay for their armed forces (Rubin 2000). Entrepreneurs had little or no incentive to become formal in this situation, and as a result they did not pay taxes and the Government therefore was not able to acquire resources to provide security or other services. Thus this vicious circle was self-perpetuating and created a strong constituency hostile to the strengthening of the government.



Source: Adapted from World Bank (2005b: 10).

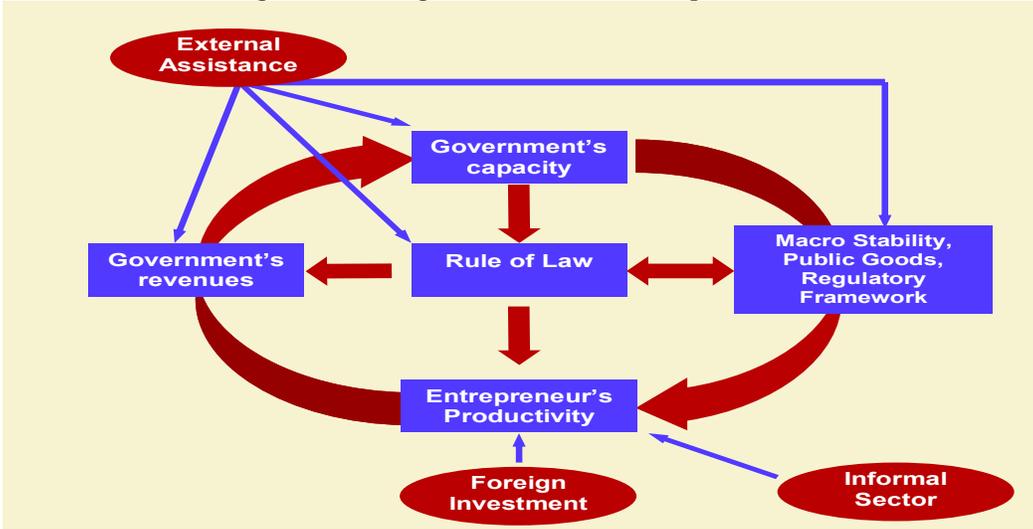
Breaking out of the informal equilibrium and moving to a “formal equilibrium” conducive to medium-term economic growth and state building requires strong actions on a number of fronts.<sup>13</sup> As suggested in

<sup>12</sup> See McKechnie (2003) for an early exposition, and also World Bank (2005b, especially Chapter 3), among others.

<sup>13</sup> The formal equilibrium does not mean that there would no longer be a large informal sector; all countries have sizable informal sectors and the share of the informal sector in the economy tends not to decline much until relatively high levels of development are achieved. In the formal equilibrium the business climate and enabling environment are conducive to emergence and dynamic growth of a significant formal sector. See World Bank (2005b, Chapters 1, 3).

Figure 7, by building its capacity the Government is able to provide public goods and enforce rule of law, which changes the incentives for private businesses so that some of them move into the formal sector. This in turn results in more tax payments to the Government, enabling it to further build capacity, incentives to go formal are thereby further enhanced, and so on. Warlords are removed from the scene through disarming their militias and forcing them to operate through legitimate political channels. External assistance is envisaged to provide additional resources to the Government to help it strengthen rule of law, provide public services, and enhance its ability to collect revenues. Foreign investment can facilitate formalization and private sector development. The informal sector can become a source of entrepreneurs and businesses that move into the formal sector. Although in many respects this is a longer-term scenario, nevertheless it shows the desirable direction of change and end-point.

**Figure 7: Moving Toward the Formal Equilibrium**



Source: Stephane Guimbert (personal communication), based on World Bank (2005b: 31).

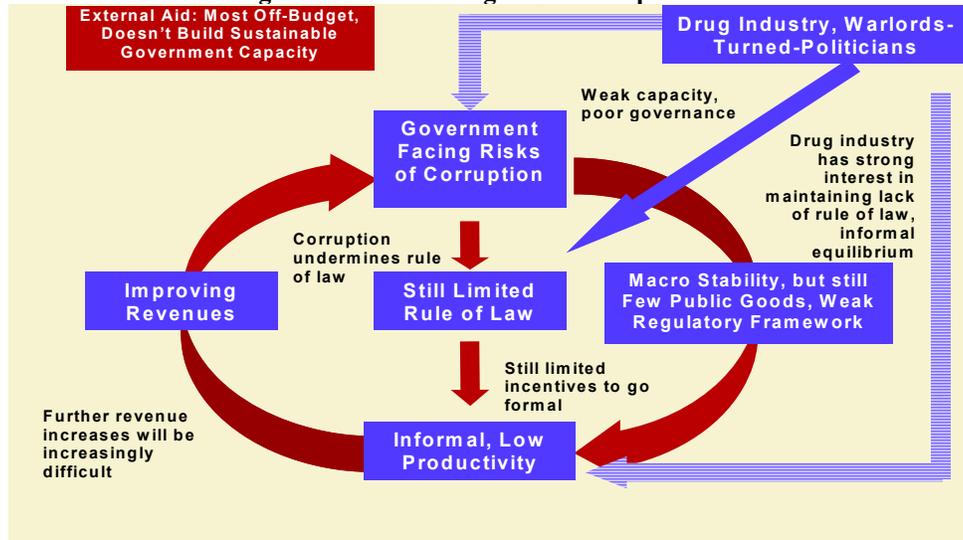
Despite the superficial attractiveness of the “formal equilibrium” scenario, it is clear that although there has been some progress in this direction (e.g. macroeconomic stability and rising domestic revenues), the dynamic trends are far from universally positive. In particular, to the extent that it may have been realistic in the early stages to effectively remove warlords from the scene (in terms of their armed militias and related political power), this has become increasingly difficult over time.

Figure 8 attempts to illustrate some of the recent trends which are of concern. Warlords and commanders in many cases have successfully entered politics, including by becoming members of Parliament or Provincial Councils, as well as in some cases by joining the Executive. This probably has undermined efforts to build the rule of law. The environment for formalization has not improved as markedly as might have been expected, and progress on the private sector development agenda has been very modest. Although some aid has supported state building (as envisaged in Figure 7), most has been channeled outside the national budget and Treasury and therefore has not helped build sustainable Government capacity. And the insurgency is undermining state building and formalization, not least by shifting attention toward conflict-related and short-term issues. As will be discussed later, the consolidation of the drug industry also is playing a very important role in undermining the Government, rule of law, and formal private sector development, including through political corruption funded by drug proceeds.

Figure 8 suggests that some key aspects of the state building and formalization agenda are going off-track, and that overall progress is being threatened by (i) the evolving political patterns in which former warlords, commanders, and conflict-generated political groupings are playing a very important role; (ii) linkages of parts of the state and some politicians with the consolidating drug industry; (iii) the continuing

and expanding insurgency; and (iv) the modalities by which most aid is delivered and the disappointing results achieved by much aid. State building in this context risks being distorted by corruption, counterproductive political practices, and interest groups formed during the long conflict.

**Figure 8: The Evolving Informal Equilibrium**

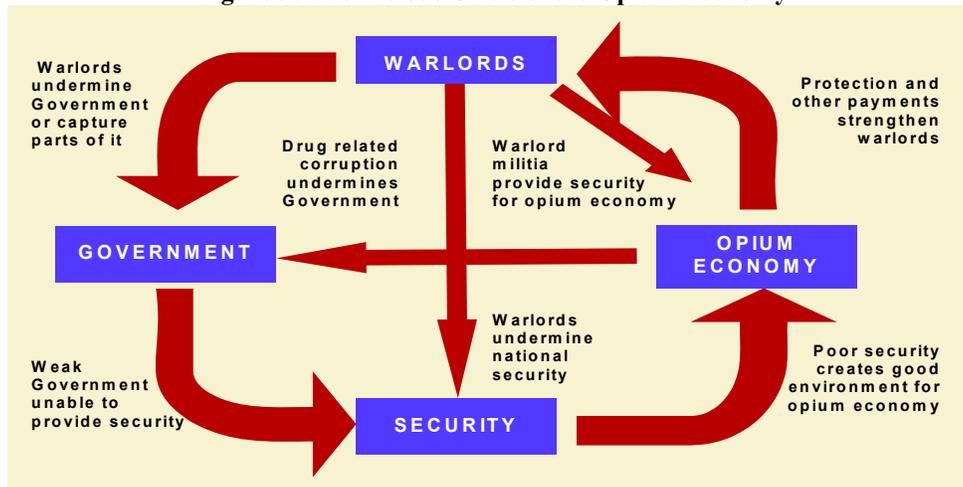


Source: Author's assessment, building on World Bank (2005b: 10).

## CHANGING DYNAMICS: THE DRUG INDUSTRY

Afghanistan's drug industry has been evolving since 2001-03. Figure 9 illustrates a vicious circle involving the opium economy, warlords, and insecurity—broadly reflecting the situation as opium output rebounded in the two years after the Taliban's downfall. In this situation, payments from the drug industry strengthened warlords, who in turn undermined the state, while drug-related corruption also undermined the state directly. In return for payments, warlord militias helped provide the enabling environment (including often armed protection) for the opium economy to operate. The weak government was unable to provide genuine security or rule of law, and this maintained an environment in which the opium economy could continue to thrive as an illegal activity.

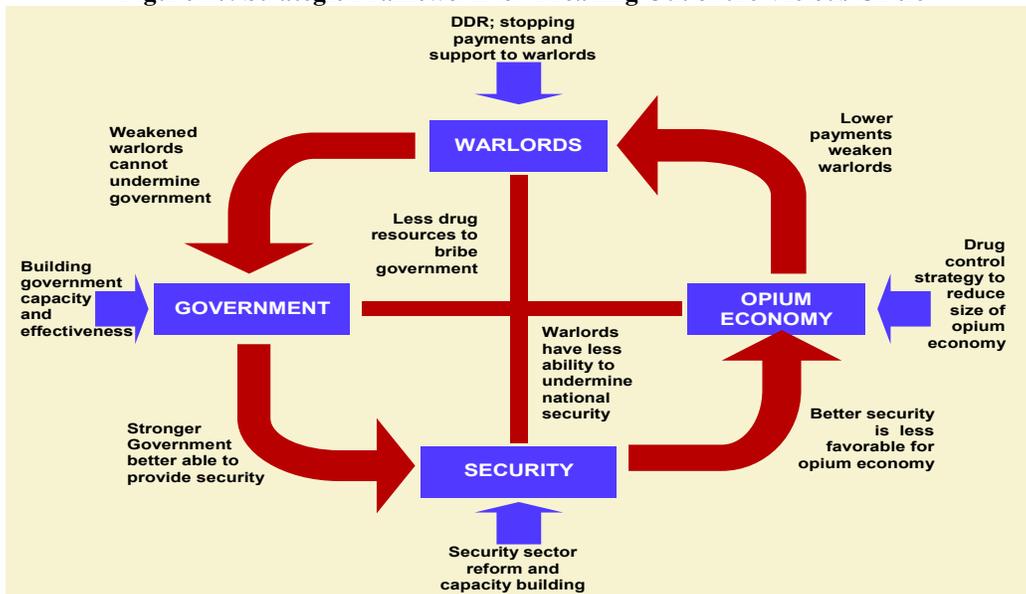
**Figure 9: The Vicious Circle of the Opium Economy**



Source: Adapted from World Bank (2005b: 120).

This vicious circle suggests that a multi-faceted strategic framework is required to effectively address the opium economy and the problems it causes for Afghanistan’s development agenda. Counter-narcotics efforts (narrowly construed) alone are unlikely to prove successful given the mutually reinforcing factors at work. Therefore a strategic framework for a more comprehensive approach to fighting drugs was put forward (see Figure 10). In addition to reducing the size of the opium economy through effective counter-narcotics measures, this framework included (i) curbing warlords’ powers by stopping payments and other support to them, DDR to take away their militias, and co-opting them into Government as appropriate; (ii) building government capacity and effectiveness as well as resources; and (iii) security sector reform and capacity building.

**Figure 10: Strategic Framework for Breaking Out of the Vicious Circle**

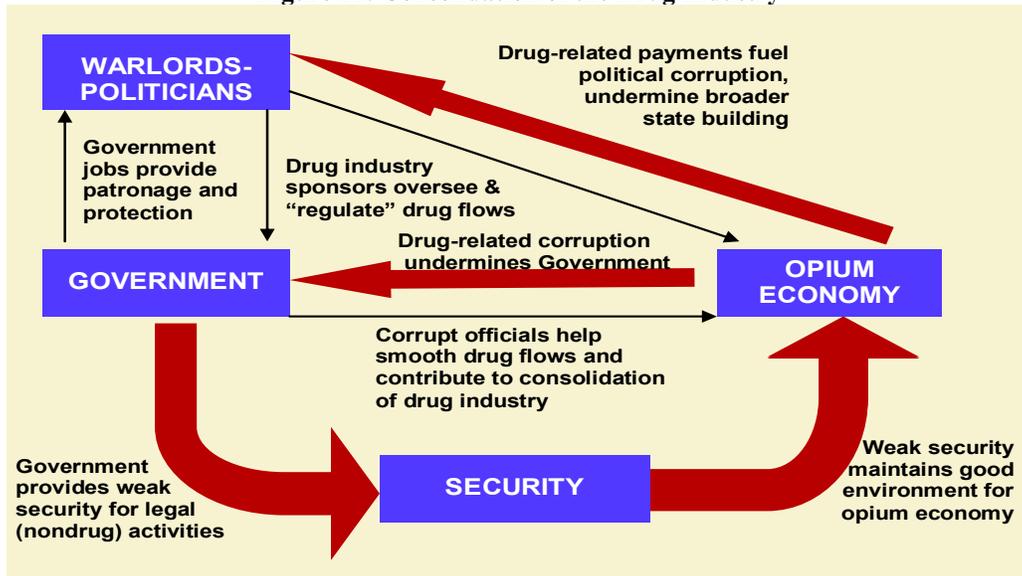


*Source: Adapted from World Bank (2005b: 127).*

In the event insufficient improvements were achieved at the broader strategic level, and counter-narcotics efforts have failed to prevent further growth of the opium economy, along with consolidation of the drug industry (Shaw 2006). As a result, both the opium problem and its adverse impacts on the state building and development agenda have worsened. As depicted in Figure 11, the transformation of warlords into politicians, working in political and governmental spheres, has been accompanied by compromising of parts of agencies like the Ministry of Interior and Police by drug interests. The triangle between drug interests, their political sponsors, and parts of the Government reflects a trend that—through widespread corruption in implementation—counter-narcotics efforts have contributed to drug industry consolidation. Security forces, most notably the police, are in part facilitating activities of the drug industry rather than countering it.

Overall, the dynamics in Afghanistan are troubling in several respects. The emerging political patterns may well be detrimental to state building; the insurgency is continuing, expanding at least in some respects, and distracting attention from the broader and longer-term development agenda and distorting priorities; the drug industry continues to fuel corruption and to undermine important parts of the Government; widespread and apparently growing petty as well as larger-scale corruption is seriously harming the Government’s credibility and legitimacy in the eyes of the people; and there is increasing discontent about the slow progress of reconstruction. Any of these trends individually would be worrisome, but taken as a whole they raise serious concerns about Afghanistan’s future path and prospects.

**Figure 11: Consolidation of the Drug Industry**



*Source: Author's assessment, drawing on analysis in Shaw (2006).*

## WINDOWS OF OPPORTUNITY

Closely related to these dynamic aspects is the issue of “windows of opportunity” that arise in different contexts (including post-conflict), which need to be exploited while they remain open. The timing and length of windows of opportunity vary for different elements of the development agenda. For example, cross-country research suggests that development aid has greater benefits during the fourth to the tenth post-conflict years, a period which Afghanistan has recently entered into; thus the window of opportunity for aid to achieve supernormal results remains wide open (Collier and Hoeffler 2004). At the opposite extreme, it can be argued that there was a window of opportunity at the very beginning (in October 2001) for international forces to occupy Kabul, which would have prevented the initial dominance by Northern Alliance forces at the center and would have made it easier to sideline warlords and factional leaders whose power was based on armed groups and conflict-related politics. This window of opportunity has long passed. Yet another example is the political window of opportunity for major policy reforms, which roughly covered the period during which the Government could legislate by decree, i.e. until Parliament was inaugurated at the end of 2005.<sup>14</sup> On the military front, the Taliban were a discredited force immediately after they were overthrown in late 2001, and for about the next two years or so there appears to have been a window of opportunity to prevent or at least greatly dampen their resurgence.

Table 4 lists some windows of opportunity for Afghanistan, related to economic recovery, aid, legal foundations, policy reforms, the political dimension, counter-narcotics, and military aspects. The longest windows of opportunity are for post-conflict aid and good policies and institutions to stimulate economic growth, whereas the shortest were military opportunities as well as the short-lived window of opportunity following the remarkably effective Taliban ban on opium poppy cultivation.<sup>15</sup> Several windows of

<sup>14</sup> Given that further institutional and policy reforms are likely to pay good dividends in terms of aid effectiveness and economic growth for some time to come, it would be beneficial to move forward with reforms, but this will be a major challenge now that the political window of opportunity has passed.

<sup>15</sup> Given the lack of sustainability of the Taliban ban and the increased underlying dependence on opium it led to, as well as incentives to expand opium poppy cultivation to new and marginal areas, this was probably an opportunity to slow and dampen the magnitude of the resurgence in opium poppy cultivation but not stop it altogether.

opportunity, in particular political, legal, and for major policy reforms, cluster around a three-year time horizon, and have now closed or at least narrowed.

**Table 4: Windows of Opportunity in Afghanistan**

Category / Window	Length of Time	Time Period in Afghanistan	Assessment	Comments
<i>For post-conflict economic growth</i>	Peaks in 4 <sup>th</sup> to 7 <sup>th</sup> year post-conflict	2002-2008 (initial years also strong)	Growth averaging 12% p.a.	Recovery from conflict & major drought of late 1990s coincided
<i>Impact of post-conflict aid on growth</i>	Seven years (starting in 4 <sup>th</sup> post-conflict year)	2005-2011 (extra benefits)	n/a – early results mixed	Post-conflict aid can achieve above-normal benefits in years 4-10
<i>Legal foundations (incl. Constitution)</i>	Bonn Agreement timeframe	2002-2004	Largely succeeded	<i>De jure</i> legitimate government established
<i>Policy reforms (political scope for)</i>	Period of technocratic government	2002-2005	Important successes but remaining issues	Government could legislate by decree during this period
<i>Impact of policies and institutions on growth</i>	Roughly same as post-conflict aid	2005-2011 (extra benefits)	Reforms have slowed with political government	Good policies and institutions can further enhance aid's impact on growth in this period
<b>Political Windows</b>				
<i>Political "honeymoon"</i>	Two to three years?	2002-2004?	Modest success but not sustained	Enormous popular goodwill for new government initially
<i>Break out of conflict-associated politics</i>	Until Parliamentary and PC elections	2002-2005	Only limited success	There was popular desire to get away from "conflict politics"
<b>Counter-Narcotics</b>				
<i>Limit rebound of opium economy</i>	One year plus	2002	Fragmented attempts failed	Successful Taliban ban in 2000; probably not sustainable
<i>Prevent consolidation of drug industry</i>	About three years?	2002-2005?	Failed	Drug industry initially not very much consolidated
<b>Military (to prevent...)</b>				
<i>Northern Alliance occupation of Kabul</i>	One month	October 2001	Failed	Opportunity for Kabul to be occupied by relatively small international force
<i>Entrenchment of warlords</i>	Six months to one year?	2002	Largely failed	More success achieved later, but at high cost of "co-opting"
<i>Taliban resurgence</i>	Two years plus?	2002-2004	Failed	Taliban discredited force during two years or so after 2001

*Source: Author's assessments; Collier and Hoeffler (2004) on post-conflict economic growth, aid, and policy.*

Overall, Afghanistan benefited from several windows of opportunity in the post-2001 period. But it is clear that minimalist approaches were taken and "satisficing" levels of effort applied, particularly in the early years, which have proven problematic now that some windows have narrowed or closed. Particularly in the military and political spheres, failure to take advantage of windows of opportunity has resulted in far more difficulties and greater resource requirements in the current situation.

Afghanistan's experience clearly demonstrates that while understandable and maybe effective in some contexts and for pursuing certain objectives, a "satisficing" or "minimum effort" approach carries grave risks in a situation where there are windows of opportunity. The very concept of a window of opportunity means that there is a limited period of time when extraordinary efforts may pay off disproportionately, and after which the same pay-offs will be much more difficult or even impossible to achieve. Moreover, during the "window" progress may appear good even without too much effort, whereas this is not sustainable with the given level of effort, and as time passes and the window of opportunity narrows or closes, that level of effort will no longer prove adequate.

Success in exploiting windows of opportunity has varied, with greater progress achieved in economic policy reforms than, for example, in sidelining warlords from Afghanistan's new politics, or in making the 2001 defeat of the Taliban "stick". Progress seems to have been better in cases where it was easily recognized that there was a window of opportunity with a clear time horizon (e.g. the period during which the Government could legislate by decree in the absence of Parliament, or the Bonn Agreement timetable for the Constitution). Where the windows and their time of closing were less clear, the need to accelerate efforts to exploit them may have been less obvious.



## **IV. KEY PRIORITIES FOR THE FUTURE**

This section discusses priorities in several critical areas of the development agenda. It does not consider the political process or insurgency, although as emphasized earlier these impinge greatly on Afghanistan's prospects. First some options on how to respond to the challenge of sustaining robust private sector-based economic growth are put forward. Then the governance agenda is discussed, including anti-corruption, public administration reform, and (related to both) public accountability. Elements of a "smart" counter-narcotics strategy also are discussed, and finally priorities for development and aid management, including technical assistance (TA) and development communication.

At the outset, the importance of the time dimension must be emphasized. From a military standpoint, conventional war is typically an all-out effort of limited duration. However, Afghanistan now faces a serious insurgency (as well as more general insecurity and limited rule of law), and insurgencies tend to stretch out over many years or even decades. In fact, the time horizon for a successful counter-insurgency effort is on the same order as that for other main elements of Afghanistan's reconstruction and development agenda—state building, capacity development, building and strengthening institutions, security sector reform, etc. This implies that all actors need to be working to a long time horizon and making choices about prioritization and sequencing accordingly. Both military and aid practices need to be aligned with a long time horizon. The understandable tendency toward short-termism needs to be avoided, while making sure that what all actors are doing in the short run is (taken as a whole) both substantial enough in relation to the challenges and leading toward longer-term objectives.

### **SUSTAINING ECONOMIC GROWTH AND SUPPORTING PRIVATE SECTOR DEVELOPMENT**

Sustaining (non-opium) economic growth will be especially challenging with important elements of Afghanistan's development agenda progressing slowly, hindered by adverse trends in political patterns, the insurgency, and the drug industry. Nevertheless there are opportunities to move forward. But first, it is important to keep in mind directions and policies which, based on international experience and conditions in Afghanistan, are not likely to work and therefore should be avoided. Some examples are listed in Box 2, including highly complex schemes especially those requiring considerable capacity, discretionary decision-making, and integrity, a trade regime characterized by extensive and differentiated protection of domestic activities; blanket subsidies and tax breaks; public enterprises; and trying to boost aggregate demand to stimulate further growth.

From a more positive perspective, some options to help stimulate private sector-based economic growth include the following:

First, at the macro level, more active exchange rate policy (i.e. depreciation of the Afghani) may help offset the adverse impact of the Dutch Disease and make production of tradables (exports and import substitutes) more attractive, thereby promoting private sector development and associated employment growth. As noted earlier, international experience suggests that an overvalued exchange rate is inimical to longer-term economic growth in developing countries. However, this option should not be pursued to the point where it significantly increases inflation and threatens macroeconomic stability.

Second, turning to the more micro level, there may be ways to break through barriers related to the investment climate by means of "enclave-type" approaches in the short run—most notably by scaling up and maximizing the effectiveness of Industrial Parks. While bringing about overall improvements in the investment climate nationwide inevitably will be a medium- to longer-term endeavor, it should be possible within the contained areas of Industrial Parks to alleviate the main bottlenecks for potential

investors—security, access to land, corruption and red tape, and infrastructure (power, water, convenient transport). It should also be possible, with an appropriate micro-level legal and regulatory framework, to enhance access to finance through collateralization of land and facilities located on Industrial Parks. Business support services and training also could be anchored in Industrial Parks. International experience with Industrial Parks, which has been decidedly mixed, suggests that in order to be successful, they need to be managed on a commercial basis, preferably by the private sector under competitive contractual arrangements. A quick review of the experience so far with Industrial Parks in Afghanistan, bringing in lessons from international experience, could serve as the basis for improving and scaling up Industrial Parks to better meet investors’ needs. It may also make sense to extend the Industrial Park Concept to include Export Zones, which could be part of a broader export promotion policy.

### **Box 2: What is Not Likely to Work in Promoting Economic Growth**

International experience as well as that of Afghanistan strongly suggest that some approaches to promoting sustained growth are unlikely to work and hence should be avoided. Examples include:

- **Highly complex schemes**—especially those requiring capacity, effective discretionary action, and an unrealistic level of integrity in the Government bureaucracy—are unlikely to work well.
- **Extensive protection of domestic economic activities via high and variegated import tariffs or quantitative restrictions.** Aside from the anti-export bias, lobbying tendencies, weakening of efficiency incentives, etc. associated with protective trade regimes, Afghanistan’s porous borders and widespread availability of the smuggling option mean that protection is very unlikely to be effective. The fact that even transport-protected activities are not taking off suggests that other constraints on businesses are operative, and that trade barriers will not work very well in promoting import substitution. Moreover, export development will not be served by a protective trade regime.
- While in principle attractive as a means of offsetting certain disadvantages (e.g. high cost of labor, barriers to exports), **blanket subsidy schemes carry numerous distortions and problems, especially in the Afghan context.** Moreover, the fiscal costs of subsidies would be high and difficult to manage given the low revenue-GDP ratio, limited donor support to the operating budget, and donors’ aversion toward paying for subsidies as part of their aid programs. Thus other ways need to be found to achieve some of the desirable effects of subsidies (e.g. making labor and exports more attractive for business) without the large direct fiscal costs and other disadvantages associated with subsidies.
- A related point is that **general tax breaks are unlikely to be very effective and would carry high costs in terms of foregone revenue** which Afghanistan can ill-afford. These are in effect subsidies delivered through the tax system and have very similar problems to direct subsidies.
- **Developing state-owned enterprises (SOEs) would be counterproductive.** Based on international experience, SOEs are not an effective or efficient way to speed up economic and employment growth.
- And finally, **boosting aggregate demand to stimulate economic growth will not work well in the Afghan situation.** Economic growth has been relatively high during the past five years. Further stimulating aggregate demand probably would have adverse inflationary consequences, would most likely contribute to greater wage inflation, and might well not result in significantly higher growth.

Another option that could be pursued is competitive contracting of international or regional firms to develop “value chains” that result in production and exports of goods from Afghanistan (with actual exports being the contractual target). Rather than trying to develop value chains through fragmented public investments and support to the private sector in different parts of the value chain (which carries a serious risk that actual exports will not materialize in the end due to other constraints becoming binding), the private sector itself could be made responsible for developing the entire value chain (with public

support as needed).<sup>16</sup> By demonstrating clear results in the form of exports, such an approach might generate more widespread knowledge and confidence in the private sector to move forward. If this kind of approach seems promising, the concept needs further thought and development; in particular there would need to be careful design of contracts (based on performance, encouraging employment generation, a focus on areas of Afghanistan's perceived comparative advantage but not too narrow – i.e. not trying to “pick winners”), and a robust competitive process (to avoid potential governance issues).

There may also be other effective ways to encourage export development and international competitiveness. Examples could include, among others, complementary investments (e.g. in cold stores for fresh produce, developing standards and quality testing, provision of some form of incentive-compatible export subsidy, export finance, insurance, etc.). Serious efforts also need to be made to establish Afghanistan as a significant brand name at least in some niche markets.

A very important means of effective and efficient import substitution is to sharply raise local procurement by international military forces, as well as pro-actively increasing local procurement in civilian aid. Only a tiny proportion of spending by international military forces at present is on goods produced in Afghanistan, reflecting military procurement rules of the respective countries rather than underlying economic considerations. Transparent, competitive local procurement (combined with support to capacity development by Afghan companies, e.g. for quality control and standards) could inject as much as \$1 billion annually into the Afghan economy and stimulate private business development.

Privatization could be a vehicle for stimulating private sector development. Many state-owned enterprises are defunct, and few of them have very high levels of staffing or production. Making the facilities, land, and real estate of SOEs available for development and utilization by the private sector may help stimulate the development of the latter. Land from state-owned enterprises, as well as other public land in good locations, could be productively used to develop Industrial Parks.

Critical business development and support services need to be encouraged, including through training of the requisite human capital. For example, the Government could contract a firm that would provide (as a fee-based service) support to Afghan businesses to write proposals and bid for public procurement contracts. Businesses' accounting could be supported (also justified by the externalities of enabling tax assessment and helping with deepening of the financial sector). There are other conventional services like insurance which are grossly underprovided. Perhaps a scheme could be considered whereby designated services would be accessed by firms through vouchers given to firms that pay taxes, as a way to encourage formalization of the economy while making sure the system is demand-driven.

Containing corruption and reducing red tape (discussed below) comprise an important element in improving the business climate. From the perspective of private sector development, it may be useful to focus on streamlining on an urgent basis the enormous number of laws, regulations, licensing rules, fees, etc. currently on the books. A possible approach might be to ask ministries to quickly prioritize the laws and regulations that are important to them (with appropriate technical guidance), and then cancel the rest. This kind of “guillotine” approach puts the onus on those who want to retain laws and regulations to provide a justification and to prioritize them.

A focus on the construction industry as a source of employment growth would make sense. For the foreseeable future, the construction industry will be a major or even dominant private sector employer in

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<sup>16</sup> A model might be, in the case of agricultural products, the practice of “contract farming” whereby large corporations (e.g. grocery chains in Europe) contract sizable farms (or farmers' associations) in developing countries to produce certain goods of an adequate quality standard for sale on their shelves, with the corporation providing a whole range of inputs and quality control to make this happen. Such corporations would not normally engage in this way with Afghanistan, but might be willing to do so if the process is appropriately subsidized by the aid community.

urban areas. The reconstruction and house-building boom definitely should foster the emergence of a sizable, efficient, and competitive construction industry in Afghanistan, as well as local construction materials production. There may also be other industries and activities that potentially would be strong sources of economic growth and increased demand for labor in the future, and could be supported.

Enterprise development can be pursued to expand business activity and livelihoods in rural as well as urban areas. Links between farmers and private agro-processing facilities will be very important in enhancing value addition in Afghan agriculture and in stimulating rural employment. An effective interface is needed for such linkages to work well, and in a context of small-scale farming, associations among farmers will be essential. A variety of models exist, and rural enterprise entities, farmers' associations, or other arrangements in the countryside could interact with agro-processing businesses.

International experience suggests that short-term vocational training programs are not likely to improve the situation unless tied to dynamic, growing sectors and firms. In a context of high growth (which Afghanistan currently enjoys in several sectors) such programs could be very useful but need to be organized for maximum effectiveness and responsiveness to labor market demand. Maybe training programs could be developed by private companies themselves and subsidized in an appropriate way.

The quality of education is a critically important determinant of productivity and private sector development over the medium term. The importance of education is likely to continue to grow, as by all indications technological progress globally has been and will continue to be biased toward skilled labor (increasing demand for educated labor relative to unskilled labor). Although the impact is long-term, improvements in education need to be initiated in a timely manner. It is in particular very important to focus on the quality of education at higher levels—there is no point in sharply increasing the numbers of university graduates if the quality of their education is so low that they become virtually unemployable (unable to compete for higher-end jobs but unwilling to take jobs with low skills requirements). Innovative, demand-driven, and commercially managed approaches to vocational education need to be developed. There is already considerable market demand for well-educated people in a variety of fields, which the education system needs to respond to in an effective manner.

There is much concern in Afghanistan about generating employment, which over the medium term will be achieved only by robust private sector-based economic growth. In the short run there is a role for well-designed and implemented public works employment programs to provide temporary employment and incomes for the poor. And there may also be a role in the short run for measures that reduce (or at least slow the increase of) labor supply in Afghanistan, thereby lowering unemployment and/or raising market wage rates. In this context, Afghan labor responds to and flows across regional labor markets, most notably in Pakistan and Iran but also farther away. Moreover, Afghan labor employed in regional markets generates flows of remittances into Afghanistan. Over the medium term the bulk of employment for Afghans will need to be generated in the country itself. But in a situation where unemployment is currently a very serious problem, a strong case can be made that in the short run the “safety valve” of regional employment for Afghans should not be closed, and in particular large flows of people and labor back into Afghanistan, ahead of expansion of domestic employment opportunities, should be avoided.

More generally, results-oriented productive cooperation between the public and private sectors can help improve the business climate and facilitate the removal of bottlenecks. While mind-set changes and cooperative attitudes need to be fostered, it is important to keep some kinds of interactions off the table—lobbying for firm-specific benefits, corruption, etc. Finally, far higher priority needs to be given to the private sector development and employment agenda by both Government and donors. While avoiding pitfalls mentioned earlier and not going for “crash programs” that are likely to prove counterproductive from a medium-term perspective, the economic growth and private sector development agenda clearly requires more attention and resources.

## STRENGTHENING GOVERNANCE

Governance problems (broadly defined) threaten to undermine the effectiveness, credibility, and legitimacy of the Afghan State and thereby the entire reconstruction and development agenda. Near-term priorities include making headway against corruption, pursuing difficult yet essential public administration reforms, and making further progress in improving public financial management. Strengthening public accountability—through external audit, to the legislature, and to the public and civil society—comprises a very important component of all three priority areas of governance.

***Anti-Corruption.*** As emphasized earlier, corruption in Afghanistan by all accounts is widespread, expanding, and increasingly entrenched. Realism is called for in considering how much can be done about corruption, and how fast. This does not mean inaction, but rather focusing efforts on achieving meaningful progress, and avoiding empty rhetoric leading to disappointed expectations. Prevention and other elements of anti-corruption strategy (including awareness raising and external accountability)—not just investigation and prosecution—will be crucial. This in turn will require developing systems, processes, capacity, and integrity mechanisms that help prevent corruption.

There are a number of critical issues that are hindering the fight against corruption. One is the need for government-wide ownership of the anti-corruption agenda. A related issue is the need to demonstrate—through actions not just words—genuine high-level Government commitment in the fight against corruption. The Government’s anti-corruption roadmap paper (Afghanistan Government 2007) puts forward a short-run action program with a number of meaningful yet feasible measures. These include, among others, follow-up on the Control and Audit Office’s audit findings related to fraud and corruption, implementation of the Constitutional provision for public asset declarations by top Government leaders, effectively implementing the agreed vetting process for high-level political appointments, and reviewing and adjusting key national laws so that they are consistent with the United Nations Convention Against Corruption (UNCAC) which was recently ratified by Parliament.

The institutional framework for fighting corruption needs to be clarified. Corruption is a quintessential cross-cutting issue, and a wide range of government agencies are involved in various parts of the anti-corruption agenda. This implies:

- There needs to be high-level inter-institutional oversight of the anti-corruption effort; no one agency can take the lead on all parts of the agenda.
- The government agencies concerned need to cooperate with each other; far too much attention seems to be focused on disputes over which agency is in the lead.
- The role of the specialized anti-corruption agency (GIAAC) needs to be reconsidered and narrowed, with more of a focus on coordination and bringing other agencies together rather than competing with them.
- Strong leadership of institutions involved in the fight against corruption is critical, and must rise to the highest ethical and professional standards.

Turning to next steps, as put forward in Afghanistan Government (2007), priorities for action include: (i) clearly expressing the Government’s commitment against corruption through promulgation of a credible action program; (ii) clarifying the institutional framework for anti-corruption; (iii) understanding better the context, problems, actors, and dynamics of corruption in Afghanistan, so as to better inform anti-corruption strategy and policies; (iv) assessing vulnerabilities to corruption in key sectors, agencies, and functions—through preparation of Vulnerabilities to Corruption Assessments (VCAs) and corruption risk mitigation plans, taking appropriate actions, and monitoring progress in anti-corruption efforts at the level

of sectors, agencies, and functions; (v) resolutely pursuing key cross-cutting reforms including public administration reform, judicial reform, counter-narcotics strategy, and strengthening external accountability (through Parliament, media, civil society); (vi) developing a national anti-corruption strategy as part of the ANDS process; and (vii) fostering support from the international community around a harmonized approach, while ensuring that leadership is firmly in Government hands.

**Public Administration Reform.** The PAR agenda is complex and difficult yet extremely important. Despite significant progress, there is still a very long way to go before the objective of a lean, effective, and accountable civil service can be achieved.

The comprehensive pay and grading reform has undergone extensive design work, and implementation is expected to start soon. There has been much analysis of the fiscal cost of the new salary structure, and adjustments have been made in the interest of fiscal sustainability. If Afghanistan's domestic revenue continues to grow rapidly, and the core budget is not overwhelmed by shifts of other recurrent expenditure liabilities to it from the donor-executed external budget, the cost of the new salary structure should be manageable.

However, sharply raising pay levels in the civil service without other necessary changes will not result in improved effectiveness, better service delivery, or greater integrity. One critical prerequisite for success is at least a certain level of basic restructuring of government ministries and agencies around their main objectives and to rationalize outdated and unnecessary structures. For example, some ministries have been formed through the amalgamation of several ministries and agencies, and in the absence of any real restructuring may still have as many as three administration departments. Even though restructuring will be a continuing exercise, basic anomalies like this should be resolved before implementing pay and grading reform.

A critical element which will influence the effectiveness and success of the pay and grading reform is the handling of those civil servants who lack the qualifications for corresponding positions in the new structure, and/or are surplus to requirements (e.g. in some of the lower-grade positions). If the exercise is carried out properly there are bound to be a number of such staff. Although there is not yet clarity on how these staff will be dealt with, it is obvious that moving them to the new pay structure must be avoided.

Another issue is the implications for pensions. Pension benefits after retirement for those moved to the new salary structure will be substantially higher, which will need to be factored into the medium-term fiscal scenario. Moreover, the transition arrangements and how time served under the old salary structure will be treated need to be specified in a fiscally responsible manner. And finally, whatever the approach taken to dealing with staff who do not move to the new pay and grade structure, they would clearly need to receive pension benefits according to the old, not the new system.

In terms of sequencing, it must be recognized that if implemented effectively—and taking into account that basic organizational restructuring will need to be done—the pay and grade reform will take considerable time, on the order of 4-5 years at least. The Government is considering proceeding on two tracks: accelerating implementation of the reform for the most senior civil servants, and moving ahead on a ministry basis (depending on which are most ready in terms of restructuring, mission statements, etc.) for the rest. This approach puts a very high premium on properly implementing the front-loaded pay and grade reform for senior civil servants, which will set an important example for the subsequent much larger exercise for more junior staff.

Finally, the quality of implementation will be critical for the success of the pay and grading reform. While expectations should not be excessively high in the Afghanistan context, there is no point in going through the exercise and ending up with a considerably more costly civil service, unless merit-based procedures

are followed adequately in the process. It will also be important to minimize the disruptions to Government and civil service functioning associated with the exercise.

Although the pay and grading reform dominates the near-term landscape of PAR, other key areas cannot be neglected. The appointment process for senior civil servants, which is handled by the Independent Appointments Board (IAB) under the Independent Administrative Reform and Civil Service Reform Commission (IARCSC), is critical. Progress has been made in instituting a regularized and at least nominally merit-based process for selecting senior civil servants, which is noteworthy particularly in the context of Afghanistan where appointments based on relationships and political affiliations, if not outright corruption, have been the norm. However, there are numerous problems with the merit-based appointment process, including shortcomings in the process itself but also related to the quality of IAB commissioners (who lead the process), IAB's support capacity, relatively limited attention to pre-screening and other preparatory efforts and consequent over-emphasis on the final interviews, etc. The IAB and IARCSC have recognized these problems and have devised an action program, including a variety of short-term and medium-term measures, to improve the merit-based selection and appointment process. Given the capacity needs and quality concerns related to this process, in the short run a sharp increase in the number of merit-based appointments of senior officials would not be desirable and should not be expected, until efforts to improve the quality of the process start bearing fruit.

More generally, the capacity and profile of IARCSC will need to be enhanced if it is to play its designated role in the pay and grading exercise and in PAR as a whole. In addition, capacity for civil service processes (appointments, performance review, human resources, etc.) in line ministries needs to be strengthened. Appointments of civil servants below the top two grades are handled by ministries, with IAB playing a monitoring role.

An extremely important area of PAR, particularly from the perspective of service delivery, is at sub-national levels (provinces and districts). As discussed in World Bank (2007), although Afghanistan has a unitary state which (with the significant exception of municipalities) sub-national levels of government are part of, the subnational level serves as the "face" of the state to most ordinary citizens, and plays a primary role in delivery of most public services (ranging from local security to education and health). The way forward is de-concentration of responsibilities within the currently highly centralized line ministries to the provincial level and below, along with greater accountability for service delivery. In this context, new institutions like the elected Provincial Councils and the Provincial Development Committees can play important roles such as prioritization of development needs, coordination, monitoring, and holding government departments accountable for their performance. The provincial and district governors, who reported to the Ministry of Interior, have had direct responsibility for police and other MoI functions. They are supposed to play a coordinating and planning role vis-à-vis other government agencies at subnational level but apparently often get involved in counter-productive micro-management of line departments' activities. Recently the Government decided to separate oversight of sub-national levels of government from MoI and created a new Directorate for this purpose, which reports to the President. This initiative may help bring greater coherence to sub-national administration, but the proliferation of other, often donor-driven coordination mechanisms at sub-national level has been a problem.

**Public Financial Management.** In PFM the priority is to maintain the momentum of earlier progress and to further strengthen PFM, including through progressively building sustainable capacity in Government to handle core PFM functions. The PFM Action Program and Ministry of Finance reform plan, both of which have received high-level approval, need to be effectively implemented.

At the macro level, maintaining progress toward fiscal sustainability is critical but will become increasingly challenging. Absorptive capacity is catching up with resource availability, necessitating hard decisions on prioritization. Further increasing domestic revenue mobilization will be essential but

increasingly difficult as the “easier” revenue sources get exploited. With the formation of Parliament as well as Provincial Councils, political pressures—both to increase expenditures and to avoid difficult measures to raise more revenues—can be expected to intensify. Managing such pressures will require a strong budget process which brings in key stakeholders earlier rather than later, and makes explicit fiscal trade-offs to promote buy-in and ownership for budgetary decisions. It is also very important to strengthen the ownership of the Cabinet in the budget formulation process and for decisions made during budget formulation.

Turning to more specific areas of PFM, key priorities include the following:

- ***Improving procurement*** by implementing the Procurement Law and building capacity for this purpose, including both in the Procurement Policy Unit (located in the Ministry of Finance) and procurement capacity in key line ministries.
- ***Operationalizing integration of the recurrent and development budgets*** (a reform already underway), including by further developing and expanding the program budgeting initiative that has been piloted in three ministries.
- ***Taking forward the provincial budgeting initiative***, while fully recognizing its limitations in the context of Afghanistan’s unitary state structure, and using it to increase funding for non-salary expenditures at sub-national levels, which have been grossly inadequate.
- ***Strengthening the internal audit function***, led by the Ministry of Finance, both in that ministry’s Internal Audit Department and in the line ministries.
- ***Expanding the computerization of salary payments and accounts*** to more line ministries and provinces.
- ***Further improving the budget formulation process*** by (i) fully implementing the Ministry of Finance’s longer nine-month budget preparation cycle; (ii) ensuring that the MTFP and preliminary annual aggregate and sector budget ceilings (which need to be made available early in the budget process) are used to make explicit difficult trade-offs and prioritization decisions, and (iii) encouraging wider stakeholder participation in the budget process, including through regular consultations with Parliament.

Monitoring of progress in PFM reforms and strengthening is an important priority. The first assessment of Afghanistan’s PFM performance according to the PEFA indicators was conducted in mid-2005, and a follow-up assessment to evaluate subsequent progress and remaining problem areas is expected soon.

***External and Public Accountability.*** This is a critically important element of both anti-corruption strategy and PAR as well as PFM, including for getting other branches of government (the legislature) and civil society actively involved in pursuing both agendas.

A first priority in this regard is to develop and make full use of the existing external financial accountability mechanisms. This will involve continuing to build the capacity of the Control and Audit Office (CAO) and strengthening its regular audit functions. Review of audit reports by Parliament, and follow-up actions by the Government as well as monitoring of such follow-up by Parliament, are critical for making the external audit function meaningful and effective.

The role of Parliament in budget formulation needs to be systematized and brought forward earlier in the process—both in the interest of improving the budget process itself, as discussed earlier, and also to enhance the accountability of the budget process. Another important element of external accountability is Parliamentary review of budget outcomes and policy discussions on the budget.

A final issue related to Parliament is the need to promote the accountability *of* Parliament, not just accountability *to* Parliament. There are concerns about risks of corruption in the activities of Parliament itself, as well as pressures from representatives on individuals and agencies in the Executive related to hiring, contracts, etc.

Public accountability of the Executive, as well as Parliament, ultimately depends on the public, both organized civil society institutions and, through the press and media, the public at large. Helping civil society institutions strengthen themselves and build capacity to become more effective is important, but transparency, information sharing, and public communication by the Government also will be essential in this regard. Development communication, one of the weak points so far, is discussed later.

## **RESPONDING TO THE CHALLENGE OF THE OPIUM ECONOMY**

The drug industry lies at the heart of the challenges Afghanistan faces in state building, governance, and economic development. Responding effectively requires, first, clarity about objectives and the time horizon. The objectives from an Afghanistan-centric view would be to reduce the country's economic dependence on opium on a sustained basis over time (i.e. not just year-to-year fluctuations) while not seriously damaging the economy or increasing poverty, and to contain and reduce the threat from the drug industry to the country's state building and governance agenda.

A second critical aspect is learning the lessons from the rich experience with counter-narcotics efforts in Afghanistan and elsewhere. Some examples are summarized in Box 3: (i) blanket eradication of opium poppy fields does not work beyond the short-run success achieved, resulting in shifts of cultivation to other places and/or a subsequent rebound in places where it was eradicated; (ii) short-term alternative livelihoods programs are costly, wasteful, and unsustainable; and (iii) inevitable corruption in the implementation of counter-narcotics law enforcement measures results in distortions and can backfire (see the earlier discussion on dynamics of the drug industry). It should also be emphasized that the drug industry is by no means a static target but rather will respond dynamically to actions against it. During the past several years the drug industry has responded effectively to reform of the Ministry of Defense (by shifting its focus to the Police and Ministry of Interior); to DDR and political "normalization" (by less open but nevertheless extensive interactions with warlords-turned-politicians); and to eradication efforts (by first spreading more widely across the country and then, when eradication also started to cover these areas, taking advantage of growing insecurity in Helmand and other southern provinces and concentrating opium production there).

These and other lessons from experience provide ample grounds for concern and for caution in use of the main counter-narcotics instruments. Inaction is not a viable alternative given the profound threat posed by the drug industry to Afghanistan's entire state building and development agenda. But there is a need to fully take into account the lessons from experience and the pitfalls encountered hitherto, and factor them into the design of counter-narcotics policies and measures. In other words, there is a need to develop a "smart" strategy against drugs (see Byrd and Buddenberg 2006). Most fundamentally, it must be recognized that counter-narcotics instruments inevitably are blunt, unwieldy, and distortionary in responding to a nimble and powerful adversary.

A sound principle is to focus efforts against those parts of the drug industry that pose the greatest danger to the nation and its development agenda—i.e. the larger drug traffickers and their sponsors, who threaten to undermine state building through political corruption and compromising of state agencies like the Police and Ministry of Interior.

A second principle is the need to take fully into account the adverse side effects and distortions of counter-narcotics instruments, which could undermine or negate any beneficial effects. A prime example is corruption. There is no point in designing a plan that would work well only if there is no corruption, when it is obvious beforehand (and based on experience) that there will be corruption in implementation.

Avoiding perverse incentives also needs to be factored into the equation. If, for example, counter-narcotics assistance (in particular for alternative livelihoods activities) is concentrated in the major opium-producing areas, other (non-cultivating) areas are likely to resent this and may even weaken their efforts to keep out the opium economy.

### **Box 3: Some Lessons from Experience with Counter-Narcotics Efforts in Afghanistan**

Experience with counter-narcotics efforts in the face of difficult challenges in Afghanistan, particularly since 2001 but also with the Taliban ban in 2000 and earlier efforts in the 1990s, provides rich lessons which should fully inform the counter-narcotics strategy and specific approaches. Three such lessons are summarized below.

First, ***blanket eradication of opium poppy fields does not work as it is not sustainable over time or at a national level.*** The two most prominent examples of apparently successful eradication are the near-complete Taliban ban on opium poppy cultivation in 2000/01 and the 96% reduction in cultivation in Nangarhar Province (at the time one of Afghanistan's largest opium producing provinces) in 2004. Within 2-3 years afterward, opium poppy cultivation had rebounded in both cases. Moreover, even at the time of the respective bans, cultivation increased sharply in areas outside the bans' purview—in Northern Alliance-controlled areas in the case of the Taliban ban, and in Helmand and other provinces at the time of the reduction in Nangarhar. Eradication is economically unsustainable, except in better-off localities where people already have viable alternative livelihoods—based on access to water, land, and commodity and labor markets. Otherwise eradication can exacerbate poverty and paradoxically increase dependence on opium, including through the impact on opium-related debt. There are reports of farmers whose opium poppy fields have been eradicated several times but who nevertheless continue to cultivate opium poppy because this is the only way they can manage (and have any hope of servicing) their opium-related debts. Beyond the debt dimension, by reducing incomes of poorer farmers, forcing asset sales, etc., eradication can weaken coping capacities and resilience, making it more likely that such farmers at the first opportunity will again turn to opium poppy cultivation. Eradication is also politically difficult to sustain. The unpopular Taliban ban undermined political support for the Taliban in some key Pashtun heartland areas, possibly making it easier for the regime to be overthrown in late 2001. The Government's campaign against drugs in 2004/05, which achieved by far its greatest (albeit temporary) success in Nangarhar, also carried significant political costs, especially in that province. And finally, from a technical standpoint eradication is chasing a moving target. As opium poppy is an annual crop, cultivated on well under 10% of Afghanistan's irrigated area, it can easily shift locations—opium traders, wage laborers, and even farmers have exhibited considerable mobility in response to changing counter-narcotics priorities.

A second lesson from experience relates to alternative livelihoods programs intended to at least partly offset the reduced incomes suffered by rural households that exit from the opium economy. Experience in Afghanistan amply demonstrates that ***short-term alternative livelihoods programs tend to be very costly in relation to their benefits and also are unsustainable.*** The quintessential alternative livelihoods projects provide cash-for-work or agricultural inputs. First it should be noted that these are only designed to replace (temporarily) some of the income foregone by not cultivating opium poppy; the bulk of such programs do not attempt to deal with the issues related to dependence on the opium economy for access to assets like land, water, credit, etc. as well as markets. A more comprehensive approach to alternative livelihoods, which then becomes akin to longer-term rural development, takes much more time. Second, pressure to spend money quickly leads to waste and opens up opportunities for corruption. Finally, "rapid" alternative livelihoods programs inevitably raise people's expectations, resulting in disappointments and undermining the credibility of the Government and external actors. There is no substitute for effective and fairly comprehensive longer-term rural development to provide viable alternatives to opium.

A third lesson is that, ***in Afghanistan's environment of weak governance and lack of rule of law, corruption in counter-narcotics enforcement efforts (both interdiction and eradication) is inevitable and undermines the objectives of the counter-narcotics strategy.*** It has inadvertently contributed to consolidation of the drug industry—around fewer, powerful, and politically connected actors. Moreover, corruption results in the adverse impact of counter-narcotics actions being felt disproportionately by poorer farmers, who typically do not have financial resources to pay bribes, or suitable connections with local power-holders to exploit. And corruption in implementation profoundly undermines the credibility and perceived legitimacy of the state.

Based on these principles, the following recommendations can be put forward:

- ***Focus eradication efforts on better-off opium poppy cultivating areas and also on areas that are new to poppy cultivation.*** Experience suggests that eradication efforts can be effective and sustainable in such areas.
- When a locality is targeted for eradication on this basis (the province is usually too big a unit for this purpose, but the district or sub-district level would be more appropriate), ***go for complete or near-complete rather than partial eradication in the locality***—this will minimize the risk of corruption in implementation and associated distortions.
- Recognizing the political difficulties involved, ***focus interdiction efforts against medium and larger drug traffickers and their sponsors.*** This will set a highly positive example for counter-narcotics efforts at lower levels.
- Given the judiciary’s weakness and difficulties in successfully prosecuting major drug figures (although progress has been made in establishing special counter-narcotics courts and training personnel), ***actors associated with the drug industry should at least be removed from their positions in government,*** which can have a powerful impact in the Afghan context by sending a strong signal of credibility.
- ***Do not throw money into short-term alternative livelihoods programs*** but rather support sensible rural development, recognizing that this will take time.
- Don’t concentrate efforts and resources too much in the main opium producing areas, but rather ***consider a kind of “containment” strategy to progressively close off large parts of the country from vulnerability to opium.***
- ***Mainstreaming of the counter-narcotics dimension in development programs is very important*** and will help in scaling up meaningful efforts on the development side. However, mainstreaming should not be approached mechanically but rather in a flexible and results-oriented manner.
- ***Equally important is the need to mainstream the development dimension in counter-narcotics strategy and actions.*** Given the importance of the opium economy, “mainstreaming” development and governance considerations in decisions, policies, and instruments for fighting against drugs makes very good sense and could help avoid problems like those encountered earlier.

## IMPROVING DEVELOPMENT MANAGEMENT AND AID EFFECTIVENESS

This will be a critical success factor for Afghanistan’s development agenda as well as for attracting, allocating well, and utilizing effectively the large amounts of international assistance that the country is expected to continue to require.

***Development Management.*** A first priority in improving development management is strengthening the leadership of ministries whose development performance has been lagging. As emphasized earlier, Afghanistan’s experience strongly suggests that progress at the sector level depends on having a competent, cohesive, empowered small Afghan leadership team running the line ministry concerned. This can be achieved in several different ways, and it is not essential (although often desirable) that the minister him or herself take the lead. But at a minimum, the ministry leadership team just below the level of the minister has to be empowered by the minister. Once a good leadership team is in place, it will actively seek to resolve other problems and constraints impeding ministry performance. While Afghanistan has severely limited human capacity at top leadership and management levels, there is ample talent, including in terms of ethnic balance, to have strong leadership teams in all main ministries.

A second key priority is continuing to enhance the budget process and the role of the budget as the central instrument for policy and reform as well as public sector resource allocation. This will be critical for attracting more donor funds through national budget channels and thereby enhancing the coherence of aid. In this regard, two key elements are strengthening the medium-term orientation of the budget and strategic prioritization. The Medium-Term Fiscal Framework is a good start but needs to be taken further, and links between the MTFF and annual budget process need to be strengthened. Over time, as planning and medium-term budgeting at the sector level improve, the MTFF can be progressively transformed into a Medium-Term Expenditure Framework (MTEF) which will provide a stronger foundation for sector expenditure envelopes. However, the key priority in the short run is to promote the use of the MTFF as a policy instrument for discussions and decisions on the budget. In particular, the medium-term consequences associated with decisions—on staffing (including notably in the security services), revenue mobilization, public investments, size of service delivery networks, and more generally the role of the state—need to be fully factored into such decisions.

A key medium-term objective is progressing toward fiscal sustainability, which can be defined in the context of Afghanistan as reaching a situation where domestic revenues are basically sufficient to cover budgetary operating expenditures. The MTFF and associated medium-term fiscal planning should continue to work toward this objective despite challenges on both revenue and expenditure sides.

Prioritization is difficult both politically and technically but is increasingly important. In the early days, when the Government's absorptive capacity was very limited in relation to the large aid flows coming in, explicit prioritization was less important. The allocation of expenditures (i.e. *de facto* prioritization) was determined by the ability of different ministries and agencies to get programs going and attract and disburse funds. As absorptive capacity has progressively increased over time, the need for and importance of explicit prioritization has increased. For some national programs, most notably the National Solidarity Program, absorptive capacity is already outrunning the availability of funds, and there are likely to be more such cases in the future. This puts greater pressure on the prioritization aspect of the budget process, which has not worked very well so far. In this regard, providing at least rough ceilings for sector development budgets early in the budget process, based on past performance as well as overall national priorities, would be helpful. It is also essential that the ANDS provide clear broad directions of prioritization, even though the specifics will need to be worked out as part of the budget process.

***Aid Management and Coordination.*** This is a critical component of development management in Afghanistan, which is so heavily aid-dependent. Unfortunately there is much that needs fixing, and lessons from the experience of the past 5-6 years (as well as international experience) appear not to be getting fully absorbed; on the contrary there are some signs of reversion to practices that had already been demonstrated not to work well during the early period of Afghanistan's reconstruction.

The ANDS is currently in preparation and is expected to be finalized in the spring of 2008. The main shortcomings of earlier strategy formulation exercises—lack of prioritization and limited consultations—have been recognized, and the ANDS process emphasizes these aspects, with a key objective of developing prioritized sector strategies. An extensive consultation process has been underway.

However, the interface of the ANDS process with aid coordination, and with the process for monitoring implementation of the Afghanistan Compact and the Joint Coordination and Monitoring Board (JCMB) set up for this purpose, raise some issues. The rationale for combining the oversight, organizational structure, secretariat apparatus, government/donor groups (eight Consultative Groups, two umbrella groups, 26 Working Groups, etc.), meetings, and follow-up for the Afghanistan Compact, ANDS, and monitoring Compact benchmarks was to ensure that the Compact and its implementation remain fully consistent with the ANDS and that there is overall national leadership. The envisioned synergies have not

materialized, however, and the heavy meeting load and still rather mechanical monitoring of Compact benchmarks may well be distracting from and interfering with preparation of the ANDS. Moreover, in addition to the JCMB/ANDS structure, there are many other forums for aid coordination. Below are listed some options for improving these processes and interfaces:

- The ambitiousness of the ANDS needs to be tempered by the time and resources available. The focus should not be on the quality of the ANDS as a document, but rather on preparation of a pragmatic, feasible, and prioritized strategy.
- Monitoring of Compact benchmarks needs to be guided by ANDS sector strategies and to focus on their substance and results.
- Oversight of implementation, monitoring, and follow-up with respect to the ANDS once it is completed should be the responsibility of regular institutions of Government.
- There is also a need to streamline what has become a rather burdensome, meeting-intensive, and mechanical process of donor coordination. The number of meetings held under the JCMB/Compact monitoring process should be drastically reduced, and the approach should be much more problem-solving in character.
- Aid coordination should focus much more focus on implementation; coordination should devolve to the Working Groups where meetings would be informal, with only a single Consultative Group (CG) to discuss major issues (rather than the current eight CGs divided along broad sectoral lines).
- Where there are bottlenecks in line ministries, the focus should be on making necessary improvements in the line ministries, rather than trying to cover the gap through more aid and associated meetings, with little prospect for success.

Better organization and management of technical assistance (TA) comprises a critical component of development and aid management, and there is an urgent need for improvements. Very large amounts—in the hundreds of millions of dollars per year—are being spent on TA, with little in the way of oversight, management, coordination, sustainable capacity building, or monitoring. There are concerns that TA is not achieving results or supporting outcomes commensurate with the resources being applied. Moreover, most TA tends to be self-perpetuating rather than helping develop the domestic capacity that will reduce the need for continuing external TA. Problems are aggravated by the very limited supply of professional and managerial Afghan talent, and the typically high reservation wages of such persons, which makes it far from easy for them to be attracted into and retained by the Government.

Although the problems of TA reflect issues in the wider aid system and cannot be solved overnight, there are some practical options for improving the situation in the short run. First, what should *not* be done: TA should not be thrown at situations in an ad hoc manner; under such circumstances it is likely to worsen the situation or indeed become part of the problem, rather than part of the solution. If not well-managed and coordinated, TA becomes much less than the sum of its parts. Thus more TA can easily have negative value added—not least in the form of added coordination problems. More specifically, TA should not be seen as a substitute for adequate Government leadership particularly at the line ministry level. TA works far better when there is effective Government leadership in the institution concerned; the two are complements not substitutes.

TA desperately needs a medium-term perspective. Typically TA contracts are of very limited duration, on the order of 1-2 years. Hence they are really suitable only for certain types of TA, e.g. discrete pieces of advisory work, and not for long-term capacity building. With short contracts, overheads and learning

curves become relatively costly. A way to ease these problems, in a fluid situation where demands change, could be to engage in longer-term contracts, framework agreements with particular firms, etc.

Having clear objectives, both for TA overall and for specific TA activities, is essential. Much TA comes into Afghanistan with vague, unrealistic, inappropriate, or virtually no objectives. While goals, particularly with respect to capacity building, need to be realistic and achievable, they also need to be meaningful, linked to the national strategy and its objectives, and monitorable. Only with clear objectives and benchmarks does effective monitoring of the performance of TA—essential for achieving meaningful results, become possible. While the Government should be the focal point of monitoring efforts, donors also need to monitor the performance of the TA they finance or provide, particularly in the case of TA not financed through the budget.

Once Government leadership is in place, TA must follow the Government’s lead and allow itself to be guided and coordinated accordingly. Options for improving the management and coordination of TA under Government leadership are outlined in Box 4.

#### **Box 4: Options for Improving the Management, Coordination, and Financing of TA**

There are various specific options for improving the management and coordination of TA, including the following (in decreasing order of ambition, difficulty, and likely effectiveness):

- ***Pooled funding of TA*** for a ministry or agency, with the TA contracted through government channels. This kind of financing mechanism fully reinforces an effectively coordinated approach to TA.
- ***A single TA provider*** for the concerned government ministry or department, which reports to the Afghan leadership of the ministry or department.
- ***A lead provider designated by the Government*** that coordinates and oversees all the TA to the unit, with the full agreement and cooperation of the other TA providers.
- ***A lead individual advisor designated by the Government***, who provides oversight and guidance to all TA, for and on behalf of the Government.
- ***Coordinated planning by multiple TA providers, under Government leadership and guidance.***
- ***Continuation of present practices but with stronger leadership, management, and oversight by the Government*** ministry or agency that is recipient of the TA.

The best option to pursue is likely to vary with conditions in different ministries and agencies, and with donors’ cohesion, policies, and constraints.

Finally, an important element of development management, which also relates to aid coordination, is public communication, both by the Government and on the part of donors. This has been a problem area, particularly in fueling the already excessively high expectations of the Afghan public, and in failing to communicate adequately the real achievements and progress made, exacerbating the problem of disappointed expectations. Thus development communication urgently needs to be enhanced. This effort must be led by the Government, but donors’ support, cooperation, and staying on-message will be very important for achieving greater success in communication than in the past.

## V. CONCLUSIONS

Afghanistan's rich experience with reconstruction and development in a complex, conflict-affected environment provides valuable lessons, both for Afghanistan and for other countries. These lessons are distilled below as principles for consideration, followed by some concluding remarks focused on Afghanistan's prospects.

### KEY PRINCIPLES

Each post-conflict and conflict-affected country is at least somewhat different. Thus a first principle is to avoid generic or "boiler-plate" interventions but rather take fully into account the *context specificity* of the country situation. This in turn requires listening to local actors and building country knowledge. An important implication is that aid staff based in-country should already be knowledgeable about the country when they arrive or should be assigned for minimum periods of 2-3 years.

While inevitably there are urgent needs and priorities which have to be responded to, keeping a *medium-term time horizon* is essential for sustained success. Particularly in the case of a persistent insurgency like that faced in Afghanistan, the time horizon for all main components of the international intervention—military (counter-insurgency), political, security, development, capacity building, governance, counter-narcotics—will be long. The different stakeholders need to fully recognize this, and work accordingly.

An important principle emphasized earlier is to *exploit "windows of opportunity"* that arise and use them as much as possible to take forward the development agenda and reduce the risk of reversion to conflict. The timing and length of windows of opportunity vary for different aspects of the agenda.

Furthermore, a *"satisficing" or "minimum effort" approach carries serious risks when there are windows of opportunity*. A window of opportunity is a limited period of time when extraordinary efforts will pay off disproportionately, and after which the same pay-offs will be much more difficult or impossible to achieve. Moreover, during the "window", progress may appear superficially good, whereas this is not sustainable and as time passes the same level of effort will no longer prove adequate.

Another related and extremely important principle is the *strategic integration* of the main dimensions of the overall agenda—state-building, security, governance, counter-insurgency, counter-narcotics, economic development. The interplay of these different elements (synergies, binding constraints, mutually reinforcing problems, critical mass issues, prioritization and sequencing, etc.) is of critical importance for the success of the entire endeavor. Strategic integration must also encompass understanding the dynamics of a situation and thinking ahead through scenarios and contingencies.

*Government leadership* is critical. Experience in Afghanistan shows that this principle should be followed even in extreme cases of state erosion and destruction, as well as in other cases where state-building remains a central element of the development agenda. Government weakness and lack of capacity must not be made into an excuse for bypassing government.

The *quality of leadership* in government agencies is a vital determinant of success. Key line ministries need to be led by competent, cohesive, empowered, and pro-active small leadership teams composed of nationals.

The *Paris Declaration on Aid Effectiveness* provides guidance for the work of the international development community. Implementing entities as well as donors and UN agencies need to make their activities more consonant with the Paris Declaration. Support for national / government leadership of the

development agenda, an integral part of the Paris Declaration, is particularly important. It also calls for use of national systems to the maximum extent possible, and for transparency and information sharing by donors.

As a very important component of government leadership, *channeling aid through the national budget* is a key principle that should be increasingly followed. While this is less important in more normal developing country situations (where typically the government has domestic fiscal resources to cover most or all of its operating expenditures), it is critical where the state is very weak (including in terms of domestic resource mobilization) and state-building is at the core of the development agenda. Although absorptive capacity may be quite limited at the outset, international experience demonstrates that it can increase considerably over time, and channeling more aid through the budget will help stimulate the necessary measures (including through learning by doing) to increase absorptive capacity. Thus “business as usual” on the part of those donors who normally work in a highly bilateral manner is unjustifiable under such circumstances. Mechanisms should be established to encourage bilateral donors to provide funding through the budget, with appropriate provisions to manage and mitigate fiduciary risks, and while ensuring strong efforts to mobilize more domestic revenues and to avoid long-term aid dependency. The ARTF in Afghanistan is a notable example of what can be accomplished through this kind of coordinated financing mechanism.

Especially for aid which does not go through national budget channels, *alignment with the national strategy, priorities, and budget* is very important. At an even more basic level, consultation by donors—both with other donors and especially with the Government—before activities are initiated, should be treated as absolutely essential, with any deviations seen by all concerned as unacceptable. Cases where the Government is, for example, asked to sign a project document with no prior consultation should become a thing of the past.

Sometimes there may be a need for *coordinated intervention by donors as a group* to encourage the government to move in a better direction or resolve a problem. Possible examples might include (based on experience in Afghanistan): (i) significant divergence from fiscal responsibility in the budget, e.g. as a result of a large across-the-board salary increase for civil servants; (ii) a pattern of problematic high-level appointments (recognizing that this is sensitive); and (iii) lagging reforms for example in the security sector, electricity sector, or justice sector. Needless to say such interventions can be sensitive, and would best occur only occasionally when the issue concerned is of great importance, and based on a broad consensus among the international community.

*Prioritization* is essential in a situation where, typically, everything is urgent. Agreeing on priorities, both within the Government and vis-à-vis and among donors, is difficult but must be pursued. A clear lesson in this regard, and a principle to be followed, is not to overload the development and reform agenda, especially in the short run. In particular, donors need to be disciplined and avoid too many added objectives and requirements, and the government needs to be disciplined in clearly prioritizing its objectives, activities, and expenditures, and in communicating its priorities to donors.

Finally, experience in Afghanistan also provides examples of *approaches and practices which should be avoided*:

- Self-designated (individually or by the donor community, in the absence of government leadership) “lead donor” arrangements, which for example have been a serious impediment to security sector reform in Afghanistan.

- Individual donors who “go their own way” and do not align their assistance with national priorities and do not go through national budget channels, which is not supporting the central element of state-building.
- Undermining of overall government leadership due to “sweetheart” relationships between individual donors and particular line ministries, which can be damaging particularly in a situation where the Cabinet may be politically fragmented.
- Going for quick impacts without taking into account medium-term dimensions and dynamic implications, for example not taking into account life-cycle costs of important decisions and investments, which turn out to be unaffordable later.

## CONCLUDING REMARKS

This paper has summarized the very real progress achieved, the problems and constraints encountered, and the priorities for Afghanistan as it faces a highly unusual, in many respects unique set of development challenges. The progress achieved provides a platform for further progress in many areas. The areas where progress has been slow or negligible, and recent adverse trends, provide grounds for concern, however.

Most of the discussion in this paper relates to the state building agenda. As emphasized earlier, state building in the context of Afghanistan appears to be at serious risk of going in directions harmful to national objectives. In stark terms, *state building loses much of its lustre and raison d’etre if it involves building a state that becomes severely undermined by corruption*—parts of which may be beholden to the drug industry or other criminal and anti-state interests on the one hand, and which is awash in petty corruption on the other hand. This would be detrimental to service delivery, rule of law, and other national objectives, but especially to the credibility and legitimacy of the state. In this context, the accelerated move toward “normal” political institutions as per the December 2001 Bonn Agreement, although fully achieved in terms of meeting the benchmarks and, at least broadly, the timetable, has also brought significant problems and side effects. Political power is still to a large extent based on past conflict-induced patterns, and there has been a failure to address the difficult legacies and human rights violations of the turbulent final two decades of the 20<sup>th</sup> century in Afghanistan.

Moving forward with building a legitimate, effective, and accountable state—a central element of Afghanistan’s overall development agenda—will require strong efforts to reduce the risk that what comes out of the process is a corrupt state that does not effectively promote national development or provide services and has lost its credibility with most Afghans. Any expectations that Afghanistan in the near future will be able to build a state that fully meets developed-country standards are highly unrealistic, but it is essential to achieve adequate progress and reasonable minimum standards in terms of security and rule of law, good governance, and increasingly basic service delivery. Although state building in Afghanistan is falling short in some crucial respects, the more positive experience in specific areas like PFM does provide some grounds for hope.

To complement “top-down” state building, i.e. building the institutions, processes, capacity, and accountability of government institutions (including at the sub-national level), there is a need for “bottom-up” approaches and generating meaningful public accountability. For example, the CDCs under the National Solidarity Program might have the potential to become a focal point for local development prioritization and monitoring.

Under the difficult conditions in Afghanistan, development and state building inevitably will be a long-term effort. However, much needs to be done in the short run, and we are left with the question of

whether the effort as a whole, including responses to the growing challenge of the insurgency, is adequate in relation to the challenges faced.

More realistic expectations are called for than in the heady days immediately after the downfall of the Taliban. But it also seems clear that the sum total of current efforts, as they are being implemented now, is insufficient to make continuing steady progress over the medium term—toward Afghanistan’s legitimate national objectives or toward the international community’s goals for the country. There is in the absence of substantial changes a risk of drift, slow progress, and backsliding. Since it cannot be taken for granted that international military forces will stay in Afghanistan indefinitely (and moreover that would not be desirable), and nor that international financial assistance will be maintained at current levels indefinitely, such a scenario would carry grave risks over the medium term. In particular, in the absence of a great deal of further progress, withdrawal of many international troops and/or a sharp cut in international financial assistance would have serious adverse consequences.

Thus some combination of additional resources and much better deployment and use of available resources will be essential to improve development performance so that Afghanistan will move toward being in a sustainable position—development-wise, financially, capacity-wise, and in terms of the Government’s legitimacy and credibility. This paper has laid out some priorities for action in the development field (broadly construed). Similar re-thinking and, as needed, bold moves (while maintaining a medium-term perspective), will be required in other key areas, including on the security front and in political patterns.

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