



SPECIAL REPORT

2301 Constitution Ave., NW • Washington, DC 20037 • 202.457.1700 • fax 202.429.6063

ABOUT THE REPORT

Despite significant progress in raising government revenue, the Afghan economy in 2014–15 suffered from its lowest economic growth since 2001, and prospects for improvement in the short run appear weak. This report puts forward some innovative, near-term measures that, combined with greater government effectiveness and potential reductions in violent conflict, could help stimulate the economy. It also highlights what should not be done, such as spreading limited resources too thin in pursuit of an excessively broad policy or development agenda.

ABOUT THE AUTHOR

William Byrd is a development economist and has been following the Afghan economy closely since 2001. He is currently a senior expert at the U.S. Institute of Peace. He has published numerous reports, articles, and papers on Afghanistan's economy, public finances, governance, corruption, political economy dimensions, drug industry, extractives sector, and development challenges.

© 2016 by the United States Institute of Peace.
All rights reserved.

SPECIAL REPORT 387

FEBRUARY 2016

CONTENTS

Introduction	2
Modest Expectations: What Can Be Done?	3
Unifying in Response to a National Emergency	4
Increasing Confidence and Stimulating Overall Demand	4
Shifting Demand from Imports to Domestic Production	6
Creating Fiscal Space	8
Combating Corruption Strategically and Selectively	9
Modest Expectations: What Should Not Be Done?	11
Role of the International Community	13
Conclusion	13

William A. Byrd

What Can Be Done to Revive Afghanistan's Economy?

Summary

- Afghanistan's National Unity Government (NUG) needs to operate more like the unified government of a country facing a national crisis.
- Tens of billions of dollars in Afghan private capital is being held outside the country, but the money is unlikely to be repatriated and invested effectively in Afghanistan unless confidence in the future increases, the NUG becomes more effective, and prospects for reconciliation and reduced violence improve.
- Near-term measures to increase confidence and stimulate the economy include (1) increasing overall demand (for example, by starting some sizable infrastructure projects, regularizing informal urban settlements, and implementing selected urban income-generation and job programs); (2) shifting demand away from imports toward domestic production (through targeting spending programs disproportionately at the urban poor, increasing local procurement, and imposing moderate import tariffs on agricultural cash crops); (3) promoting export value chain development for high-value cash crops; and (4) creating fiscal space (including limited government borrowing).
- Corruption needs to be combated strategically and selectively; too broad an approach, let alone comprehensive, would divert attention from the most important corruption problems and squander limited political capital.
- Economic reforms and development programs that are too broad could also divert attention and resources away from a priority agenda and be counterproductive in the short run; examples include quick privatization of numerous public enterprises; efforts to quickly reduce opium poppy cultivation; expensive, long-gestation, financially unviable railway investments; excessive tax concessions to promote private investment; and the thin spreading of limited resources across numerous, small rural projects.
- If the Afghan government takes urgent actions to revive the economy—including through greater political effectiveness—the international community must respond proactively and flexibly by funding high-level expertise to support economic management and innovative programs, front loading aid to support priority initiatives, and restructuring project portfolios to shift funding toward activities that achieve faster results.

ABOUT THE INSTITUTE

The United States Institute of Peace is an independent, nonpartisan institution established and funded by Congress. Its goals are to help prevent and resolve violent conflicts, promote postconflict peacebuilding, and increase conflict management tools, capacity, and intellectual capital worldwide. The Institute does this by empowering others with knowledge, skills, and resources, as well as by its direct involvement in conflict zones around the globe.

BOARD OF DIRECTORS

Stephen J. Hadley, (Chair), Principal, RiceHadleyGates, LLC, Washington, DC • **George E. Moose** (Vice Chair), Adjunct Professor of Practice, The George Washington University, Washington, DC • **Judy Ansley**, Former Assistant to the President and Deputy National Security Advisor under George W. Bush, Washington, DC • **Eric Edelman**, Hertog Distinguished Practitioner in Residence, Johns Hopkins School of Advanced International Studies, Washington, DC • **Joseph Eldridge**, University Chaplain and Senior Adjunct Professorial Lecturer, School of International Service, American University, Washington, DC • **Kerry Kennedy**, President, Robert F. Kennedy Center for Justice and Human Rights, Washington, DC • **Ikram U. Khan**, President, Quality Care Consultants, LLC., Las Vegas, NV • **Stephen D. Krasner**, Graham H. Stuart Professor of International Relations at Stanford University, Palo Alto, CA • **John A. Lancaster**, Former Executive Director, International Council on Independent Living, Potsdam, NY • **Jeremy A. Rabkin**, Professor of Law, George Mason University, Fairfax, VA • **J. Robinson West**, Chairman, PFC Energy, Washington, DC • **Nancy Zirkin**, Executive Vice President, Leadership Conference on Civil and Human Rights, Washington, DC

MEMBERS EX OFFICIO

John Kerry, Secretary of State • **Ashton Carter**, Secretary of Defense • **Gregg F. Martin**, Major General, U.S. Army; President, National Defense University • **Nancy Lindborg**, President, United States Institute of Peace (nonvoting)

The views expressed in this report do not necessarily reflect the views of the United States Institute of Peace, which does not advocate specific policy positions.

To request permission to photocopy or reprint materials, email: permissions@usip.org.

Introduction

Reviving the Afghan economy during a time of intensifying violent conflict, declining external financial aid, and ongoing political uncertainty and dysfunction will be extremely challenging. But the effort cannot wait; a “normal” sequencing of ending the conflict first (or at least greatly reducing the scale of fighting), and only then focusing on economic revival and reconstruction, will not work. There is no sign that the conflict, which has been endemic for almost four decades and has worsened recently, will let up soon, and it would be irresponsible to ignore the economy while the war continues without an end in sight. Similarly, reviving the economy cannot wait for Afghanistan’s deep-seated political issues to be resolved. The country’s political arrangements are fragile, with risks of a breakdown or, more likely, continuation of ad-hoc, day-to-day political management and little prospect for political consolidation let alone political progress in the near term.

Conventional, “business-as-usual” economic approaches that might be appropriate in other situations will not work in Afghanistan. The Afghan government has enunciated, and has begun to implement, an impressive, wide-ranging reform program—most of which makes good sense from a development perspective.¹ But these initiatives, however meritorious in their own right, will not by themselves make a significant dent in Afghanistan’s economic problems. There is a need to think creatively while recognizing the limits to what can be done in a time of conflict and maintaining modest expectations.

Afghanistan can be simply characterized as a demand-driven, supply-constrained, highly open economy, which faces an enormous structural fiscal gap and weak government revenues for the foreseeable future. Over the past 3–4 years, the rapid decline in international military expenditures in-country as a result of the drawdown of international troops constituted a major negative demand shock to the Afghan economy. This resulted in a sharp economic slowdown, with growth of the country’s overall gross domestic product (GDP) in 2014 estimated at only 1.3 percent (the lowest level since 2001) and no significant improvement in 2015 (growth currently estimated at the same level of 1.3 percent).² The weakening economy also reflects loss of business and consumer confidence, lack of private investment and low and declining public investment, and deepening uncertainty regarding the political transition and security outlook.³ The continuing political infighting within the NUG has compounded all the uncertainty and contributed to weak demand and investment. Capital flight and human flight, already significant, have mushroomed over the past two years.

The factors that explain the sharp slowdown in economic growth during 2013–15 will in all likelihood continue to drive developments in the near future. Afghanistan is also vulnerable to various potential adverse shocks that include (1) major, sustained gains by the Taliban insurgency; (2) further weakening and lack of sustainability of the Afghan National Security Forces (ANSF); (3) breakdown of the NUG, greatly exacerbating political uncertainty and perhaps leading to some kind of new arrangement or possibly even open conflict among contending non-Taliban factions; (4) worsening tensions over electoral reform, the parliamentary (and perhaps district council) elections, and the holding of a *loya jirga* (grand national assembly); (5) bad weather (following several years of relatively good harvests, poor precipitation or a drought severely affecting agricultural production easily could result in negative overall GDP growth); and (6) natural disasters (the possibility of a natural disaster of a magnitude sufficient to have a macroeconomic impact cannot be ruled out). Overall, absent shocks of the kind listed above, growth can be expected to remain very low, perhaps in the 2–4 percent per year range.

There has been significant progress in mobilizing government revenue, which is estimated to have increased by around 20 percent in 2015—a welcome change from the declining trend since 2011. However, it is still far from reversing the decline in the revenue-to-GDP ratio that has been occurring since 2011. At best, it will be another 2–3 years before this ratio returns to its 2011–12 peak of 11.6 percent.

While expectations should be kept modest, near-term measures that could improve confidence and stimulate the economy include (1) increasing overall demand; (2) shifting demand away from imports toward domestic production; (3) stimulating exports; (4) creating fiscal space through not only mobilizing more domestic revenues and restructuring and economizing on expenditures but also responsibly borrowing money (including from the central bank); and (5) reducing corruption, especially in key areas such as revenue mobilization and government procurement. Conversely, there are also some areas that the government, with limited political capital and capacity, should not take on in the short run to avoid diverting attention and resources from a small, strategically prioritized agenda.

A combination of the above measures and others will be needed to break through the strong headwinds the Afghan economy faces. However, the measures should be developed and pursued flexibly, allowing room to let some fall by the wayside, if ineffective, and to take up others that present unforeseen opportunities and synergies.

Modest Expectations: What Can Be Done?

First and foremost, expectations about economic recovery and growth must be kept modest. The longer-term projections of GDP growth in the 4–6 percent per year range—put forward several years ago by the World Bank⁴—almost certainly represent the upper end of the range of the possible, unless there is a breakthrough in ending the insurgency and achieving peace. Returning to the near-double digit growth seen in the previous decade would be impossible, except perhaps in the initial years of a genuine, sustainable, postconflict situation. Lest this view be seen as overly pessimistic, getting back to 4–6 percent annual growth would constitute a major improvement over the 2013–15 growth performance. Moreover, if growth volatility could be kept lower (in particular through maintaining the relative stability of agricultural production), that would constitute significant progress. Indeed, just maintaining positive economic growth in the current situation would be an achievement.

The short-term fiscal crisis, on top of the enormous structural fiscal gap that Afghanistan faces over the medium term, is an even more pressing issue than the country's overall economic weakness. Expectations of major progress in further improving the fiscal situation also need to be modest and realistic, though recent revenue performance is encouraging. The general pattern of an overall fiscal gap well into the double digits as a ratio to GDP—largely attributable to the high cost of ANSF—which can only be bridged by aid, will not change for the foreseeable future.

Promoting a modest economic revival must start with political leadership and better government functioning. Beyond that, some economic measures can be taken to help build confidence and stimulate overall demand (or at least mitigate the drop in demand), shift demand toward domestic supply and away from imports, stimulate exports to exploit foreign demand, and create fiscal space and ameliorate the fiscal crisis. In addition, the impact of actions and investments in terms of enhancing the supply capabilities of the Afghan economy should be factored into the policy equation, though such actions would achieve results only over time. Measures that further more than one of these objectives, and achieve synergies across them, should be prioritized.

Promoting a modest economic revival must start with political leadership and better government functioning.

Unifying in Response to a National Emergency

Worldwide, national unity governments cobbled together due to domestic political problems that could not be handled through the normal political process typically have short time horizons, struggle to function effectively, are unstable, and, with different parties maneuvering for short-run advantage, frequently fail (leading to new elections in the case of parliamentary systems). There is, however, a more promising model: national unity governments formed by the coalescence of different political groups in response to what by consensus is perceived as a “national emergency.” Most often, this stems from an external military threat; the United Kingdom’s national unity government during World War II is a notable example among several. This analogy does not apply directly to Afghanistan, which faces a complex combination of internal and external threats. Nevertheless, a government that responds strongly and in a unified manner for the duration of the “emergency” is clearly needed. Rather than political infighting and short-run positioning, Afghanistan’s NUG should begin to act more like the unified government of a country facing a national crisis—which it clearly is—and focus on addressing the serious, arguably almost existential challenges in the current situation. This may sound naïve and unrealistic, but it represents a necessary condition for Afghanistan to make meaningful progress in addressing its economic and other problems.

The current political complexity and near-gridlock are not immutable characteristics of the Afghan polity but rather have been shaped by recent events and decisions.

In this context, simplifying the politics would be helpful. The current political complexity and near-gridlock are not immutable characteristics of the Afghan polity but rather have been shaped by recent events and decisions. The U.S.-led international intervention in 2001, for example, empowered a disparate set of regional and local warlords who had been defeated or sidelined in the mid- to late 1990s and would not have come back, let alone become entrenched, in the absence of the international support extended to them. More recently, the internationally mediated outcome of the 2014 presidential election weakened the new incumbent in what is constitutionally a strong presidential system and created several new top leadership positions, further complicating the politics. Yet another example is former president Hamid Karzai’s endurance on the political scene, not as an elder statesman above the fray but as a political actor engaging in day-to-day political debates. The complexities of Afghanistan’s “two-headed” NUG are difficult enough to manage without a third potential power center in the picture, physically located within a stone’s throw of the presidential palace.

Most recently, some political figures opposed to the NUG have publicly asserted that, contrary to its text and the accepted outcome of the 2014 presidential election, the NUG agreement will “expire” after two years (i.e., in September 2016). Moreover, they argue, if parliamentary and provincial council elections and a Constitutional Loya Jirga are not held by that time, either early elections or a “traditional” loya jirga will be required.⁵ These kinds of irresponsible statements risk further undermining confidence among different stakeholders in political stability and in the longevity of the NUG.

Can something be done to simplify the politics? Can Afghanistan’s NUG move toward multiparty cohesion in the face of a national emergency? Could some political leaders, who already had well over a decade in power, make way for new leadership by voluntarily exiting from the day-to-day politics, which would be an exercise of genuine statesmanship? Can the international community avoid inadvertently undermining and instead more effectively support statesmanlike behavior and discourage the petty political rivalries that are eroding the government’s credibility vis-à-vis internal stakeholders and external partners?

Increasing Confidence and Stimulating Overall Demand

There are no sources of demand that would come anywhere near to financially offsetting the negative demand shock of declining international military expenditures and aid in

Afghanistan. There is, however, potentially billions of dollars in Afghan private capital held in neighboring and nearby countries, as well as further afield. Encouraging large amounts of this money to be repatriated and invested productively in Afghanistan would provide a major boost to demand and economic growth. However, this cannot be expected to occur to any significant extent unless confidence in the future increases, the NUG becomes more effective, and/or prospects for reconciliation and reduced violence improve. Within a broader context where improvements are being made in at least some of these areas, several specific measures may help to enhance confidence, lengthen perceived time horizons for private business, and increase demand in the economy.

Starting some sizable infrastructure projects. While infrastructure projects have long gestation periods and enhance the supply capabilities of an economy only over time, starting some sizable projects would also have concrete short-term benefits for Afghanistan. Such projects would increase demand for labor and various goods and services, thereby augmenting aggregate demand. More important, credible infrastructure project starts send a strong signal of both the government's and international partners' commitment to the medium-term development agenda. This, in turn, may well increase confidence among the population (to make purchases, stay in the country) and in the private business sector (to maintain or increase activities, make business investments). The focus should be on a few key "signature" projects to avoid spreading limited resources across numerous underfunded public investments—none of which would make much progress toward completion.

Regularizing informal urban settlements. Rapid urbanization in Afghanistan has occurred to a large extent through informal settlements (often on public land), where residents seldom have any legal claim to the land they occupy. Providing official documentation and legal security of tenure for residents of informal urban settlements would boost confidence, lengthen time horizons, and provide stronger incentives to improve their properties.⁶ Such a program could also reduce pressures for human flight—people with a meaningful stake in the residential real estate they informally occupy might think twice about leaving the country. In addition, modest public spending could enhance access to and mobility within these settlements (e.g., streets and pathways) and provide basic services as well as improvements in the local environment (e.g., greenery, better drainage). Effective safeguards would be needed to prevent corruption or inadvertently validating warlords' claims to large tracts of land (as opposed to household-size plots for individual families). The Afghan government is already pursuing an initiative along these lines, and this is a low-cost way to improve the confidence and sense of security of relatively poor urban residents, while also generating a moderate increase in demand in the economy.

Implementing selected urban income-generation and job programs. Resources for development programs are woefully inadequate, especially for new initiatives of any size. Therefore, in the short term, programs with multiple objectives aimed at building confidence, increasing demand (at least modestly), and alleviating poverty should be prioritized. This rules out large, nationwide, rural programs—no matter how effective and beneficial from a development perspective—that would spread resources thinly across numerous small investments and activities and not have a short-term visible impact. Selected urban public works and income-generation programs—well-designed, effectively implemented with good governance, and focused on a few large cities—would be more likely, in conjunction with other measures, to help break the current economic impasse. Some (though not all) of the programs in the Afghan government's proposal of November 2015 may align well with this approach.⁷ Specifically, two of the eight proposed programs appear to be highly consistent with this kind of prioritization: "labor-intensive urban clean-up and repair" and "fortifying urban peripheries."

Providing official documentation and legal security of tenure for residents of informal urban settlements would boost confidence, lengthen time horizons, and provide stronger incentives to improve their properties.

Shifting Demand from Imports to Domestic Production

In Afghanistan's ultra-open economy, measures to increase demand as a whole will not necessarily translate into higher national production and incomes—a large part of higher demand will spill over into imports and probably, in the current situation, contribute to capital flight as well. A promising but not much discussed option is to move demand away from imports toward domestic production, provided that the shift occurs in areas where a domestic supply response is possible. Similarly, increasing exports would enable the Afghan economy to benefit from foreign demand, stimulating domestic production and incomes in the process.

Prioritizing spending programs that target or disproportionately benefit the poor. The poor tend to spend a larger part of their budgets on domestically produced goods and services, whereas wealthier people may, for example, purchase imported consumer durables and other imported luxury goods. Thus, targeted spending programs would have both macroeconomic and poverty reduction benefits. Whether enabled by increased public resources (including through aid) or by resources shifted away from lower-priority activities, such programs are worthy of serious consideration. However, their effective implementation with good governance would be necessary to achieve results. Moreover, the programs should target the urban poor to avoid spreading limited resources across numerous, small, and much less visible rural investments, even if the latter have merit on development grounds.

Increasing local procurement. Increasing preference for Afghan companies in government procurement and incorporating domestic content requirements in public contracts are good approaches. The Afghan government and, to some extent, the international community are already pursuing them, but they should do so even more vigorously, particularly where Afghan companies and the labor force can be responsive based on existing underutilized capacity. In conjunction with the government's welcome initiative to combat corruption in public procurement, increasing local procurement can achieve considerable economic benefits. In the medium term, measures to increase local procurement should be supported by efforts to enhance the supply capabilities of the Afghan economy, such as increasing infrastructure investments, building human capital in a demand-responsive manner, improving the business climate for the private sector, and developing business support services.

Imposing moderate, broad-based import duties on agricultural cash crops and products. This represents a more radical option for shifting demand. In the case of agricultural cash crops, a supply response is possible based on past experience. Agricultural cash crops provide one of the only areas of comparative advantage for Afghanistan in the short term, and in some localities, they have performed well.⁸ However, the country's potential for cash crop development has not been fully realized for several reasons: There are large-scale competing imports of many agricultural products, reflecting Afghanistan's open markets (which can get flooded by low-cost imports from neighboring countries through well-established trading networks); lack of storage capacity and seasonal factors that sometimes result in reimportation (at higher prices) of exported Afghan agricultural products; lack of farm-to-market transport as well as domestic blockages and other cost-increasing factors (e.g., insecurity and corruption, including at police checkpoints); and in some cases, actual or perceived quality issues. Given these factors, and because most countries protect and/or subsidize their agriculture sectors, it is not surprising that imports often have an artificial advantage over Afghan products.

A modest, broad-based tariff would help contain imports of vegetables and fruits, as well as products that require limited processing (e.g., jams) that can be and are being grown in Afghanistan, stimulating increased domestic production of these goods. The rate of import duty should be significant enough to give Afghan goods an advantage, or at least level the playing field, but not so high that it creates additional opportunities and incentives for

corruption in the Customs Department. Nor, for the same reason, should the rate of duty be differentiated across agricultural products. While smuggling is a risk and would reduce the effectiveness of the tariff in discouraging imports, the tariff could, in conjunction with ongoing reforms in the Customs Department to reduce corruption there, play a positive role in shifting incentives away from imports toward domestic production.

However, food-grain (primarily wheat, in the case of Afghanistan) should not be subject to such a tariff. Wheat is disproportionately consumed by the poor and, in any case, is not the crop of Afghanistan's future. It is a low-value crop that uses a considerable amount of land and water in relation to its value but not much labor. Thus, while achieving food self-sufficiency is an appropriate objective—and Afghanistan already reaches around 80 percent food self-sufficiency in bumper harvest years—there are no export prospects for Afghan wheat, and the real potential for agricultural development lies in high-value, labor-intensive cash crops, which are much more appropriate for Afghanistan's resource endowment and constraints.⁹

Promoting comprehensive export value chain development for high-value agricultural products through export promotion grants. On the export side, numerous value chain weaknesses and obstacles inhibit a major increase in agricultural cash crop exports, even for fruits where appearance and quality pose less of a problem (e.g., melons, pomegranates). Despite the constraints, exports of some cash crops have soared in recent years (albeit starting from a tiny base), with support from the United States Agency for International Development and other donors. Nevertheless, there is much more unrealized potential to exploit in nearby markets, such as India, the Gulf States, and more generally in the Middle East and South Asia.

One approach not yet tried in Afghanistan takes its inspiration from the “contract farming” model that is widely used internationally. Retail grocery chains in high-income countries, for example, develop ties with groups of farmers in developing countries, whereby they purchase the fruits and vegetables the latter produce, observe quality and phytosanitary standards required in the importing country, and provide technical assistance and other services to ensure that producers have the capability to meet those standards and deliver the products on time. Much lower labor and other costs in the producing country make contract farming attractive for the grocery chains, and stable financial returns and capacity development make this model attractive to the farmers.

Contract farming develops naturally in reasonably well-governed developing countries—it is most unlikely to emerge on its own in Afghanistan, where insecurity; bad governance; poor infrastructure; bad logistics; an uneducated rural labor force; and other daunting problems deter businesses in importing countries from initiating contract farming themselves. However, these businesses have intimate knowledge of and connections with consumer demand and downstream parts of the value chain and often some experience in working with suppliers and supporting value chain development in other developing countries.

Rather than trying to substitute for the private sector by making fragmented public investments (which even if they address some of the value chain gaps would leave in place other binding constraints to exports), a better option would be to make it worthwhile for businesses at the demand end to engage in something resembling contract farming in Afghanistan. Export promotion grants could offset the extra costs of doing business in Afghanistan and make it attractive, or at least feasible, for foreign businesses to engage and deliver exports of labor-intensive, high-value cash crops, including through necessary technical and other support to Afghan farmers.¹⁰

In addition to the (initially fairly modest) direct results from increased exports, livelihoods, and incomes and development of the capabilities of the farmers and other Afghan businesses involved, this approach would have positive demonstration effects. Over time, other entrepreneurs and businesses could develop their activities along similar lines, potentially scaling up exports in a major way.

Export promotion grants could offset the extra costs of doing business in Afghanistan and make it attractive, or at least feasible, for foreign businesses to engage and deliver exports of labor-intensive, high-value cash crops.

Any financial grants to help jump-start Afghan agricultural exports must be performance-related, time-bound, and effective. An approach worth exploring would be to issue competitive tenders where a specified quantity of exports of certain cash crops—exported to and actually sold in the importing country—is the contracted deliverable, and companies bid on the amount of grant they would require to achieve the targeted exports and sales.¹¹ Contracts would cover a specified time period, after which they could be rebid, with an expectation that the level of grant required would decline over time and eventually become unnecessary. Where a value chain obstacle cannot be resolved by private sector action but rather relates to government regulation and other government-related problems (e.g., delays and red tape at the border/airport), the contractor would bring these problems to the attention of the Afghan government and the concerned donor(s) for resolution.

Creating Fiscal Space

As noted earlier, the fiscal crisis has been the most urgent problem on the economic front. In 2014, a combination of declining Afghan government revenues and expenditure pressures led to a budgetary shortfall (which the government assessed at US\$537 million), severe cash flow problems, and arrears of around US\$200 million on government contracts and other payments. In response to the government's emergency request for aid, donors provided US\$190 million, but the fiscal situation has continued to be tight.¹²

In addition to addressing immediate budgetary shortfalls, creating fiscal space will provide greater scope for development-oriented programs and activities. Fiscal space can be generated by (1) increasing revenues (e.g., new tax measures, more effective collection, reduced corruption in government revenue agencies); (2) economizing on and restructuring expenditures in favor of higher-priority spending (e.g., restructuring of donors' current and planned projects); and (3) borrowing by the government.

The Afghan government, with international support, is pursuing the first two approaches. There has been an encouraging turnaround in the revenue picture: After three years of stagnation and declines (and a three percentage point drop in the ratio of revenue to GDP), revenue increased by around 20 percent in 2015. This represents a major improvement, which has enabled the government to avoid suffering from a year-end fiscal crunch, unlike in 2014. The government and donors are also working to restructure expenditures toward higher-priority programs that can deliver more timely results.

However, there has been virtually no consideration of borrowing. In a stagnant economic situation (growth barely over 1 percent per annum in 2014 and 2015), with low inflation¹³ and no near-term balance of payment problems,¹⁴ tight fiscal policy is a harmful contractionary force that could worsen the macroeconomic situation. Yet that is exactly what the no-overdraft policy does. Instituted soon after the downfall of the Taliban in late 2001, the policy, under which the Ministry of Finance's balance of deposits with the central bank (Da Afghanistan Bank—DAB) was not permitted to turn negative, played a positive role in the early years. In particular, it sent a strong signal of fiscal probity following the hyperinflation of the 1990s and buttressed and enhanced the credibility of the successful currency reform in 2002–03. Moreover, growing international military expenditures and aid, which reached extraordinarily high levels by the end of the previous decade, meant that the tight fiscal stance embodied in the no-overdraft policy did not have adverse macroeconomic consequences in such an environment of high demand and rapid growth. However, the no-overdraft rule arguably has outlived its usefulness. Currently, modest government borrowing and associated fiscal deficits would have an appropriately stimulative effect on the economy or at least not make it worse.

Currently, modest government borrowing and associated fiscal deficits would have an appropriately stimulative effect on the economy or at least not make it worse.

In 2014, the government incurred a domestically financed, monetized budget deficit equivalent to 1.7 percent of GDP¹⁵ by drawing down its deposits at the central bank, with no discernible adverse effects on inflation or the balance of payments. Since such deposits have now fallen to low levels, it is no longer feasible to finance significant deficits solely by further drawing down deposits; instead, borrowing from DAB (by running an overdraft or by issuing bonds purchased by DAB) would be required to achieve the same level of much-needed fiscal flexibility. In addition, the government could issue bonds (these could be Islamic bonds—*sukuk*) for sale to the Afghan public, which could fund government development programs. Indeed, if the government started acting more like the unified government of a country facing a national emergency, sale of “patriotic bonds” could mop up at least a small part of the enormous wealth accumulated by some Afghans over the past dozen years.

Any government borrowing would have to be limited and responsible and should be closely monitored and adjusted in line with macroeconomic developments. Borrowing from the central bank (which implies money creation) does not raise debt sustainability issues since the state is in effect borrowing from itself. It does have implications for inflation and for the stability of the foreign exchange rate and hence should be limited to no more than 2 percent of GDP. Inflation and exchange rate trends should be followed to ensure there is no undue adverse macroeconomic impact. Borrowing in domestic currency from the Afghan public can and should be developed over time, but it must not lead to unsustainable domestic debt, requiring debt sustainability analysis. The most risky form of government borrowing—on foreign markets and denominated in foreign currency (e.g., U.S. dollars)—may not be appropriate for Afghanistan at this point and for some time to come.

Combating Corruption Strategically and Selectively

Pervasive and entrenched corruption is both an outcome and a symptom of Afghanistan’s underlying malaise and also represents a major constraint and obstacle to progress. While the NUG has rightly emphasized fighting corruption as a policy priority, there are serious challenges and difficult trade-offs—not least because various forms of corruption have become ubiquitous and allocation of “rents,” including proceeds from corrupt activities, has become part and parcel of the country’s political arrangements. Appointments to government positions have been a key instrument in this regard, and unfortunately, the formation of the NUG perpetuated a “spoils” approach to high-level appointments. Government contracts, mining tenders, and various public services and regulatory mechanisms also serve as key vehicles for corruption.

In the current political environment, overly broad, ad-hoc, and unstrategic measures against corruption could backfire politically and result in loss of the limited credibility and political capital of the government. Moreover, the pervasiveness of corruption in various forms, combined with limited technical capacity and political will in the government, means that it would be impossible and most likely counterproductive to try to tackle corruption universally or across numerous sectors and agencies at the same time. Too broad an approach, let alone a “comprehensive” anticorruption strategy, would divert attention from key priorities and squander limited political capital and resources without achieving the results that a narrow and more concentrated agenda could enable. Thus, careful prioritization will be essential.

Addressing corruption in the near term should involve prioritizing areas where

- **Integrity is an essential ingredient of effectiveness and economic and/or fiscal impact.** In these areas, anticorruption efforts must be prioritized and carried out no matter how difficult. Addressing corruption in the Customs Department and at border

In the current political environment, overly broad, ad-hoc, and unstrategic measures against corruption could backfire politically and result in loss of the limited credibility and political capital of the government.

crossings is a good example, because this is essential for enhancing revenue receipts and the effectiveness of the proposed tariff on agricultural cash crops. Procurement reform, which the government is already pursuing vigorously, is another example.

- **Corruption is having a significant impact on many people's daily lives.** Selected areas where there are visible manifestations of public discontent over corruption, and where timely action is feasible and could lead to meaningful, positive results, may be worth targeting for near-term anticorruption action. Government regulation and some basic public services may fit this criterion.
- **Though not necessarily significant in terms of direct economic or fiscal impact, anticorruption actions would be highly visible and important symbolically.** These areas may set the tone for the government's credibility and how it is perceived both domestically and internationally. Asset declarations for top government leadership and senior officials, required both by Afghanistan's constitution and under applicable laws, may be worthy of pursuit on these grounds. Even more important than the asset declarations per se is their review, vetting, and publication.¹⁶
- **Actions meet several of the above criteria and can be pursued vigorously.** Kabul Bank, with its huge financial losses and resulting fiscal hole, its high-level political connections, and its great visibility both within Afghanistan and internationally, is a good example.

On the other hand, in some areas where corruption has to be tackled before an activity can be pursued further, it may well be better to hold off in the short run. If the activities concerned will not be beneficial if corruption remains out of control, it would be better to wait and focus both sectoral policies and anticorruption efforts elsewhere. Extractive industries represent a prominent example. Corruption needs to be tackled up front for exploitation to be more beneficial than harmful, and since controlling corruption in this activity appears to be impossible for now, it would be better to hold off on new mining contracts and development in the short run.

The key point is that the limited resources, attention, and above all the meager political capital available to the government for fighting corruption must be focused on a few key priorities—no more than about a half a dozen—that could make a significant difference in the short run. Based on the criteria discussed above, priority efforts could include the following: (1) root out corruption in the Customs Department and on main border crossings; (2) clean up government procurement, especially in the case of larger contracts; (3) accelerate the recovery of lost and stolen funds from Kabul Bank; (4) properly vet and publish asset declarations for top public officials; (5) clean up, restructure, and move toward privatization of several public enterprises where corruption and illegal activities are a salient problem; and (6) address petty corruption in a few public services and government regulatory functions that are highly visible and considered important by the public.

The government is already pursuing initiatives in several areas, particularly (1), (2), and to some extent (3). Moreover, ongoing government efforts in key related areas, such as public financial management, also reduce vulnerabilities to corruption. But overall, it is crucial to be selective, maintain focus, strategically prioritize, and avoid taking on too large and broad an anticorruption agenda in the near term. A focused, narrow set of anticorruption initiatives is much more likely to bear fruit than a broader, comprehensive approach. Once success is achieved in at least some priority areas, the progress can be built on. Furthermore, moving forward successfully on a limited anticorruption agenda will send a credible signal that the government is determined and able to act in this area.

A focused, narrow set of anticorruption initiatives is much more likely to bear fruit than a broader, comprehensive approach.

Modest Expectations: What Should Not Be Done?

What not to do should also be clear. Taking on too broad a reform program would divert attention from priorities and spread limited resources too thin—and most likely would be counterproductive in the short run. Not only should the number and breadth of initiatives be limited, but it would be useful to delineate some areas for taking up later. As in the case of corruption, trying to do too much too fast could detract from success in pursuing a more focused agenda. Examples of areas to hold off on include the following:

Accelerating the exploitation of Afghanistan’s mineral resources with no development or fiscal benefits. Afghanistan has valuable underground resources, which could eventually benefit national development and provide significant revenues for the Afghan budget. In the short run, however, trying to accelerate the exploitation of mineral resources will be counterproductive. The institutions are not there to regulate and oversee mining activities, and existing resources are simply being captured by politically connected actors and armed groups, resulting in wanton, wasteful, and environmentally damaging exploitation, as well as out-smuggling with associated corruption. Some of the mineral resources being exploited are often magnets for conflict. It is striking that the government is receiving negligible revenues from ongoing mining of lapis lazuli, chromite, gold, and other minerals, despite there being government contracts in effect with the concerned mining companies.¹⁷

The sensible approach is to hold off on developing new resource exploitation and issuing contracts for that purpose, while focusing efforts on better oversight and monitoring of existing mines and ensuring that these activities at least yield some revenues for the government. In the case of large “mega-mines”—such as the Aynak copper and Hajigak iron resources—caution is called for and expectations of large revenues quickly accruing to the government would be misplaced. Oil and gas development in the north appears to be more promising in the near term, in particular because some exploitation is already occurring and these resources would substitute for high-cost imports of fuel and energy, and because it should be easier to ensure that at least some government revenues accrue from these activities.¹⁸

Rapidly privatizing many public enterprises. A similar rationale applies to the wholesale privatization of Afghanistan’s public enterprises. Given that most of these companies tend to be small, the benefits of trying to do too much in this field would be more than offset by the risks of privatization going wrong—including through corruption in the privatization process. A selective focus on two or three important public enterprises may make sense, particularly if they are losing money and constitute a drain on the national budget (e.g., New Kabul Bank).

Trying to quickly reduce opium poppy cultivation. From a longer-term development point of view and governance and political economy perspectives, Afghanistan’s status as the largest global producer of illicit opiates is highly problematic. In the short run, however, not much can be accomplished by drug control measures to quickly and sharply reduce poppy cultivation. The reduction in the total poppy-cultivated area, lower yields, and much lower estimated production of opium in 2015 were not due to counternarcotics actions to any significant extent but rather reflect crop failure, declining yields, and farmers’ decisions not to plant as much poppy given poorer and more uncertain financial returns. In recent years, an increasing proportion of Afghanistan’s poppy cultivation area has been in former desert areas where irrigation by expensive tube wells is required and where disease, low yields, and partial crop failure have subsequently made much of the opium poppy cultivation in those areas financially unviable.

Over the medium term, Afghanistan needs to reduce its dependence on opium production, which has extremely damaging effects on the country’s governance, security, political dynamics, and economy. In the near term, however, and in view of Afghanistan’s weak economy, prioritizing drug control actions, let alone trying to quickly engineer a sharp reduction in opium

poppy cultivation, would be damaging to the economy and to the livelihoods of many rural households. Moreover, ill-considered counternarcotics actions, such as large-scale eradication or aerial chemical spraying, would be counterproductive and could, for example, lead to more support for the Taliban and other antigovernment groups. Opium bans are unsustainable except in areas where suitable conditions are already in place (reliable irrigation water, relatively low person-land ratio, proximity to urban products and labor markets and decent road connections, and a modicum of security and government presence).

Instituting excessive tax concessions and related measures to promote private investment, in the face of other binding constraints. The key obstacles to private investment in Afghanistan—and those preventing repatriation of the substantial amounts of Afghan capital held outside the country—stem from political uncertainty and potential instability, the worsening security situation, and associated short time horizons for business investments. Moreover, weak consumer and public sector demand resulting from declining international expenditures, lack of confidence, and the enormous fiscal gap—which implies expenditure tightness and little public investment—mean that private sector opportunities are quite limited. Trying to offset these severe obstacles to private sector development (PSD) through tax concessions is unlikely to have any positive effects, unless and until the more fundamental constraints are eased. On the contrary, the negative revenue and other consequences of such actions may well outweigh any benefits.

Devoting too much attention and resources to pursuing a conventional, technical PSD agenda. More generally, while pursuing a generic technical PSD agenda makes sense from a medium-term perspective and it may not be harmful to get started on such an agenda, this will not make much of a difference in the near term. Leadership attention and resources should not be diverted from trying to make headway against the binding constraints to PSD. Conventional PSD initiatives and reforms—however well-designed and appropriate from a technical perspective on PSD¹⁹—will not significantly improve the economic situation in the short run.

Starting expensive, long-gestation, financially unviable railway projects. There has been much talk about engaging in an ambitious, large-scale railway investment program (beyond just connecting Afghanistan's near-border cities like Mazar and Herat with railway networks in neighboring countries), and some preliminary preparatory work on specific railway projects has gotten underway. However, a sober analysis indicates that large railway investments are not likely to be economically viable until the export of mineral products becomes a major customer of railways—the near-term prospects for which are virtually nonexistent. Moreover, there would be pressures to include passenger services as well as freight on any sizable railway lines constructed, but passenger railways around the world survive on government subsidies, which would impose an unmanageable budgetary burden on Afghanistan given the enormous underlying fiscal gap that will continue for the foreseeable future.

As emphasized earlier, in the infrastructure sector, it would make sense to focus on starting no more than two or three major projects that would have visibility in the short run and also are of top priority for Afghanistan's development. In this regard, water conservancy projects (which also can generate hydropower) are good candidates. Another example, which has been discussed since 2003 and is long overdue—and would have had a relatively quick gestation—is the Shiberghan gas-fired electric power plant in the north, which could provide additional electricity supply and reduce Afghanistan's dependence on imported power.

Spreading extremely limited development resources thinly across numerous, small rural projects. Afghanistan is home to some world-class rural development programs, which have achieved impressive results; the National Solidarity Program is a notable example. Nevertheless, extremely limited resources should not be spread thinly across numerous small projects,

as provided for in rural national programs, despite the medium- to longer-term development benefits. Reviving demand, restoring confidence, and building the government's credibility in the near term require a focus on selected job and income-generation programs, concentrated in larger cities. Donors, understandably inclined toward devoting more funding to successful rural programs, need to resist this tendency in view of the immediate economic pressures.

Role of the International Community

If the Afghan government does take serious actions to revive the economy—including through greater political effectiveness—the international community should respond creatively and flexibly. Both nonfinancial and financial support would be called for, including

- **Supporting the Afghan government in issuing bonds and running modest monetized fiscal deficits** (e.g., via the International Monetary Fund program), and providing reassurances that this would not result in lower international aid than otherwise would be contributed.²⁰
- **Funding high-level expertise and technical inputs, as needed and requested by the government**, to help strengthen economic management and design innovative programs (such as those proposed in this report); it cannot be business as usual on the advisory and technical side—the best of practical, policy-oriented, and context-sensitive advice must be applied to this challenging situation.
- **Being prepared to reallocate and front load aid to support initiatives as they get more fully developed**—recognizing that a proactive, experimental approach is called for, involving sensible risk taking and risk management.
- **Working closely with the government to thoroughly review and ruthlessly restructure portfolios of donor-funded projects** (current and planned) and to shift the funding freed up toward activities that disburse more quickly and achieve faster economic and development results.
- **Actively encouraging the government to respond in a unified manner more in line with the urgency of the situation**, and avoiding inadvertently contributing to the complexity of the politics in Afghanistan.²¹

Conclusion

A modest economic revival in Afghanistan will require a combination of actions that taken together can stimulate moderate growth in the near term. Neither business-as-usual nor conventional economic policy measures will be successful in the current situation, and short-term reform and policy agendas must focus on key interventions that can make a difference now. This report has proposed some ideas that may, once further developed and in combination with other potential options, begin to shore up economic growth, even if it will inevitably remain substantially lower than it was during the previous decade.

Notes

1. The various internationally agreed-on reform programs the Afghan government has entered into are concisely summarized in a recent World Bank publication. See Mohammad Omar Joya, Claudia Nassif, Mohammad Aman Farahi, and Silvia Redaelli, *Afghanistan Development Update October 2015* (Washington, DC: World Bank, 2015), 14, Box 1, <http://documents.worldbank.org/curated/en/2015/10/25218611/afghanistan-development-update-october-2015>. Details are provided in the government's papers for the London Conference in December 2014 and the Kabul Senior Officials Meeting in September 2015, as well as in International Monetary Fund and World Bank documents.

2. International Monetary Fund estimate, as reported by an Afghan government official in Kabul, January 2016.
3. Various factors have unnecessarily worsened uncertainty in recent years, including the long delay in the Afghan government signing the Bilateral Security Agreement with the United States, the U.S. government announcement in the summer of 2014 that its troop drawdown from Afghanistan would be completed by the end of 2016, the long, drawn-out presidential election process, the problematic NUG agreement, the NUG's overly ambitious and rather contentious political agenda, and the NUG's slow start and widely perceived lack of effectiveness.
4. See Richard Hogg, Claudia Nassif, Camilo Gomez Osorio, William Byrd, and Andrew Beath, *Afghanistan in Transition: Looking Beyond 2014* (Washington, DC: World Bank, 2013), <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:23052411~pagePK:34370~piPK:34424~theSitePK:4607,00.html>.
5. See, among others, Mujib Mashal, "Afghan Government Faces New Set of Rivals," *New York Times*, December 20, 2015, www.nytimes.com/2015/12/21/world/asia/afghan-government-faces-new-set-of-rivals.html?_r=0.
6. See, among others, Hernando De Soto, *The Other Path: The Invisible Revolution in the Third World* (New York: Harper and Row Publishers, 1989).
7. See Government of Afghanistan, "Jobs for Peace: A Proposal for an Economic Smoothing Program for Afghanistan," transmitted to international partners by Afghanistan's Minister of Finance on November 15, 2015, and publicly launched by President Ghani on November 17 (see www.tolonews.com/en/afghanistan/22376-ghani-launches-national-employment-program).
8. For example, when opium poppy cultivation was eliminated in areas that had a modicum of security, good access to irrigation water, and proximity to urban agricultural product markets and labor markets, these areas successfully shifted to vegetables and dairy products. After 1–2 years of transition, farmers were often better off than when they had been cultivating poppy. See, among others, William A. Byrd and David Mansfield, *Afghanistan's Opium Economy: An Agricultural, Livelihoods, and Governance Perspective* (Report prepared for the World Bank Agriculture Sector Review, June 2014).
9. Reliably irrigated land is a critical constraint for Afghan agriculture and hence for the overall economy, whereas agricultural labor is relatively abundant. Wheat is a low-value crop that requires little labor and is relatively water-intensive in relation to its value. This is out of sync with Afghanistan's resource endowment—expanding the area cultivated with wheat would result in a deterioration of the food security of the rural population, and shifting all land to wheat cultivation would result in rural destitution and likely starvation. Thus, although wheat will always be an important agricultural product and increasing and stabilizing wheat production based on raising yields makes good sense up to the point where food self-sufficiency is achieved, expansion of the wheat cultivated area should not be prioritized in Afghanistan's agricultural development strategy.
10. Many larger companies in developed countries have corporate responsibility objectives and programs, and some of these companies may be interested in participating in this kind of scheme from that perspective. Export promotion grants along the lines proposed in this paper could enable such companies to engage without incurring large financial losses.
11. Selection of cash crops and products should be on the basis of identified high potential in regional markets but should exclude some goods (if any) whose exports have already taken off and are well on-track for further sustainable export growth without need for financial support.
12. For a discussion of the 2014 fiscal "perfect storm" and its ramifications, see William A. Byrd, "Afghanistan's Continuing Fiscal Crisis: No End in Sight," Peace Brief no. 185, U.S. Institute of Peace, 2015, www.usip.org/publications/2015/05/15/afghanistans-continuing-fiscal-crisis-no-end-in-sight. See also Omar Joya, *Afghanistan Economic Update, April 2015* (Washington, DC: World Bank, 2015), www.openknowledge.worldbank.org/handle/10986/21894.
13. Inflation as measured by the consumer price index was 1.4 percent in 2014 and appears to have been negligible in 2015. See Joya, et al., *Afghanistan Development Update October 2015*, 22, Appendix Table 1.
14. Afghanistan runs a large current account balance of payments deficit, but it is financed by aid and international military expenditures; the country's foreign exchange reserves exceed US\$7 billion and are equivalent to around eight months of imports—a solid cushion for managing the balance of payments and the exchange rate (which has been gradually depreciating).
15. This figure is drawn from the reference to the core discretionary budget balance found in Joya, et al., *Afghanistan Development Update October 2015*, 24, Appendix Table 3.
16. Asset declarations for top government leaders are mandated in the Constitution, which provides for them to be made public.
17. See Javed Noorani, "Afghanistan's Emerging Mining Oligarchy," Special Report no. 358, U.S. Institute of Peace, 2015, www.usip.org/publications/afghanistan-s-emerging-mining-oligarchy. The author provides an analysis based on five case studies of mines currently being exploited by politically connected private companies under government contracts, with contract provisions being ignored and virtually no revenues accruing to the state.
18. In these cases as well, compromises and pay-offs to powerholders are probably inevitable. However, given, in particular, the import substitution benefits of oil and gas development, this may well be a price worth paying, whereas in the case of solid mineral resources, the trade-offs are much less favorable for Afghanistan in the short run.
19. See Richard Ghiasy, Jiayi Zhou, and Henrik Hallgren, *Afghanistan's Private Sector: Status and Ways Forward* (Solna, Sweden: Stockholm International Peace Research Institute, 2015), www.sipri.org/research/security/afghanistan/sipri-afghanistan-report-october-2015/view. This report provides a wealth of background and detail and puts forward sixteen clusters of recommendations for various stakeholders.
20. On the contrary, donors should welcome the greater flexibility that modest government borrowing would provide for short-term fiscal management—not least because this option should obviate the government's need to request ad-hoc assistance to help fill budget shortfalls, thereby enabling donors to focus on supporting the policy, reform, and development agendas.
21. For example, by meeting at the ambassadorial or other senior levels with Afghan political figures who have been—contrary to the text of the NUG agreement itself—arguing that the NUG has a two-year time span and will lose its legitimacy thereafter, international partners may inadvertently give the impression of validating such arguments or of engaging in hedging behavior. These kinds of mixed signals need to be avoided.

ISBN: 978-1-60127-405-2

An online edition of this and related reports can be found on our website (www.usip.org), together with additional information on the subject.

Of Related Interest

- *Provincial Governors in Afghan Politics* by Dipali Mukhopadhyay (Special Report, January 2016)
- *Effective Monitoring and Evaluation in Conflict-Affected Environments: Afghanistan Post-2014* by David Mansfield (Peaceworks, November 2015)
- *Afghan Economic Policy, Institutions, and Society Since 2001* by Paul Fishstein and Murtaza Edries Amiryar (Special Report, October 2015)
- *Afghanistan's Continuing Fiscal Crisis: No End in Sight* by William A. Byrd (Peace Brief, May 2015)
- *Afghanistan's Emerging Mining Oligarchy* by Javed Noorani (Special Report, January 2015)



**United States
Institute of Peace**

2301 Constitution Ave., NW
Washington, DC 20037

www.usip.org

