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State Building, Sustaining Growth, and Reducing Poverty

A Country Economic Report

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CURRENCY EQUIVALENT

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GOVERNMENT FISCAL YEAR

March 21 – March 20

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2002/03 = 1381

2003/04 = 1382

2004/05 = 1383

ACRONYMS AND ABBREVIATIONS

ACD	Afghan Customs Department	MDG	Millennium Development Goals
ADB	Asian Development Bank	MIWRE	Ministry of Irrigation, Water Resources and Environment
AFMIS	Afghan Financial Management Information System	MoC	Ministry of Commerce
AIHRC	Afghan Independent Human Rights Commission	MoF	Ministry of Finance
AISA	Afghanistan Investment Support Agency	MRRD	Ministry of Rural Rehabilitation and Development
AMF	Afghanistan Militia Forces	MSTQ	Metrology, Standards, Testing and Quality
ANBP	Afghanistan New Beginnings Program	NATO	North Atlantic Treaty Organisation
AREU	Afghanistan Research and Evaluation Unit	NDB	National Development Budget
ARTF	Afghan Reconstruction Trust Fund	NDCS	National Drugs Control Strategy
ASP	Afghanistan Stabilisation Program	NDF	National Development Framework
BCM	Billion Cubic Meters	NEEP	National Emergency Employment Program
BPHS	Basic Package of Health Services	NSC	National Security Council
CAO	Control and Audit Office	NSP	National Solidarity Program
CND	Counter-Narcotics Directorate	O&M	Operation and Maintenance
CSO	Central Statistics Office	PAREM	Public Administration and Economic Management
DAB	Da Afghanistan Bank	PIP	Public Investment Program
DDR	Disarmament, Demobilization, and Reintegration	PMU	Program Management Unit
EC	European Commission	PPA	Performance-based Partnership Agreement
EU	European Union	PPP	Purchasing Power Parity
GDP	Gross Domestic Product	PRR	Priority Reform and Restructuring
HIPC	Highly Indebted Poor Countries	PRT	Provincial Reconstruction Team
IARCSC	Independent Administrative Reform and Civil Service Commission	PSP	Provincial Stabilisation Plan
ICD	Inland Clearance Depot	SSR	Security Sector Reform
IDA	International Development Assistance	UNAMA	United Nations Assistance Mission to Afghanistan
IDP	Internally Displaced Person	UNDP	United Nations Development Program
IMF	International Monetary Fund	UNICEF	United Nations Children's Fund
IRC	International Rescue Committee	UNIFEM	United Nations Development Fund for Women
ISAF	International Security Assistance Force	UNODC	United Nations Office on Drugs and Crime
LOTFA	Law and Order Trust Fund	WSS	Water Supply and Sanitation
MAAH	Ministry of Agriculture and Animal Husbandry	WUG	Water User Group
MAPA	Mine Action Plan for Afghanistan		

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ABSTRACT

Afghanistan has come a long way since emerging from major conflict in late 2001. Important political milestones mandated by the Bonn Agreement (two Loya Jirgas, a new Constitution) have been achieved. The economy has recovered strongly, growing by nearly 50% cumulatively in the last two years (not including drugs), with double-digit economic growth expected to continue in 2004. Some three million internally and externally displaced Afghans have returned to their country/home. More than four million children, a third of them girls, are in school, and immunization campaigns have achieved considerable success. The Government has supported good economic performance by following prudent macroeconomic policies; it has begun to build capacity and has developed the nationally-led budget process and made the budget into its central instrument of reform; and it has made extraordinary efforts to develop key national programs (for example employment and community development programs) and to revive social services like education and health.

Nevertheless Afghanistan remains one of the poorest countries in the world in terms of both per-capita incomes and social indicators, with large gender gaps. The difficult challenge of poverty reduction is made even more difficult by continuing insecurity, weak rule of law, and narcotics. Worsening security in many parts of the country threatens to derail reconstruction, undermine state-building efforts, delay parliamentary elections and adversely affect other aspects of political normalization, reduce private sector activity, and keep it in the informal/illicit economy. The burgeoning growth and spread of opium production during the last two years (now accounting for about a third of the Afghan economy and three-quarters of global illicit opium production) has fueled insecurity and funded anti-government interests including terrorist networks. Drugs, insecurity, “capture” of large parts of the country by regional powerbrokers, and the weak capacity of the state (including difficulties in centralizing revenue) all contribute to a self-reinforcing “vicious circle” that would keep Afghanistan insecure, fragmented politically, weakly governed, poor, dominated by the informal/illicit economy, and a hostage to the drug industry.

Afghanistan, with robust support from the international community, has to break out of this vicious circle – and move toward a “virtuous circle” whereby improving security, state capacity building, revenue mobilization, formal private sector development, and sensible, coordinated actions against drugs all reinforce each other and put Afghanistan on a path of sustained economic growth and poverty reduction. This will require simultaneous progress on several key fronts; actions in any one area alone will not be effective given the strong interests working to maintain the current status quo. On the other hand limited resources and capacity dictate that the Government prioritize core reforms that will enhance governance, focusing on the implementation of ongoing tasks rather than going for a large number of new initiatives. As the report discusses in detail, the essential elements for a breakthrough in the next 1-2 years include:

Enhancing security and rule of law – through vigorous security sector reform and capacity building (especially the Afghan National Army, police force, and justice system), combined with external security assistance including outside of Kabul.

State building through increasing capacity and intensifying public administration reforms, with a focus on enhancing center-periphery relations (with provincial and district administrations), revenue mobilization, and service delivery (national programs, social services, basic infrastructure).

Further political normalization, focused on making key institutions (cabinet, legislative bodies, judiciary) work effectively, with neutralization of warlords and other illegitimate powerbrokers.

Maintaining economic growth with macroeconomic stability, and **pro-actively pursuing private sector development** through a good enabling environment, support services, and capacity building within the private sector.

Meaningful, coordinated actions against drugs, consistent with the overall state-building, security, and development strategy.

Enhancing the effectiveness and efficiency of international assistance, focusing on the attainment of core reforms and enhancing donor alignment with the national budget.

This is a daunting agenda, which will require strong commitment, actions, and persistence on the part of the Government. In each area listed above sustained, coordinated assistance from the international community will be required. Moreover, the international community can support Afghanistan's state-building and reconstruction agenda by (i) maximizing assistance that goes through government budget channels and moving toward programmatic support; (ii) maximizing use of coordinated Government-led Technical Assistance mechanisms, and coordinating pay policy with the Government; (iii) stopping payments and other support to non-legitimate regional authorities; and (iv) standing ready to respond to macroeconomic shocks (e.g. drought) by accelerating and adjusting assistance as needed.

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EXECUTIVE SUMMARY

BACKGROUND

1. Afghanistan is emerging from more than two decades of conflict, capped by a severe nationwide drought in 1999-2001, and faces a complex, interrelated set of political, administrative, economic, and social challenges. The energy and resilience of the Afghan people, which served them well during this period, is now being channeled into securing their livelihoods, rebuilding a credible state, and restoring the country's economy. Their efforts, with Government leadership and political, financial, and military support from the international community, have already borne fruit in the form of rapid economic growth, rising incomes, initial revival of public administration, and other improvements. There is near-universal popular sentiment for peace, security, and prosperity. Despite these gains, Afghanistan remains among the poorest countries in the world (average per-capita GDP of around US\$300 including opium), and it is a highly fragmented society where the authority of the Government is contested. Continuation of recent positive developments is subject to serious risks – political, security, drug-related, macroeconomic, institutional, and climatic.

2. The Government has set forth a compelling development vision in its *National Development Framework* (NDF), articulated into a detailed strategy and expenditure program in its recent report *Securing Afghanistan's Future: Accomplishments and the Strategic Path Forward* (SAF). The vision and strategy encompass state-building, security, private sector-led growth, human development, and political and social progress, with the key national objectives of sustained broad-based economic growth and poverty reduction.

3. This is the first Economic Report on Afghanistan by the World Bank in a quarter-century. It is intended to contribute to a better understanding of the core challenges that lie ahead for the country and key strategic priorities for national reconstruction. It does not repeat the analysis and investment requirements set forth in the SAF document, but instead focuses on the conceptual frameworks, policies, and institutions that will be needed to achieve core national objectives of state-building; sustained rapid, broad-based economic growth; and poverty reduction. Analysis of the Afghan economy is hindered by severe data limitations (discussed in the Statistical Appendix) and is challenged by the conflict-related economic structure and dynamics that have emerged during the past two decades. Nevertheless much has been learned about how the Afghan economy functions, at least in qualitative and institutional terms. The report also draws on the great volume of work done on individual sectors and topics by the Government and partners.

4. This report starts with a description and analysis of the Afghan economy and its recent performance (Chapter 1), and the poverty situation (Chapter 2). Chapter 3 outlines a strategy for growth and poverty reduction, based on the NDF/SAF, and puts forward key strategic priorities and directions for implementation. State-building, discussed in Chapter 4, lies at the core of Afghanistan's reconstruction as well as progress on political, security, and other fronts. Chapter 5 addresses the development of the private sector, which will have to be the engine of growth and poverty reduction in Afghanistan. Agriculture, covered in Chapter 6, comprises half of the economy and will play a crucial role. Chapter 7 examines Afghanistan's opium economy, which has some short-term economic benefits but very serious adverse effects on state-building and security. Chapter 8 looks at delivery of social services, a key component of the poverty reduction strategy, including the gender dimension. Social protection – strategies and programs to assist the poorest and most vulnerable members of Afghan society – is discussed in Chapter 9. Chapter 10 concludes with a summary of priorities for action, implementation constraints, prospects, and risks.

THE AFGHAN ECONOMY AND RECENT PERFORMANCE

5. The starting point – in late 2001 at the fall of the Taliban – for recent developments in Afghanistan was dire. The Afghan economy was reeling from protracted conflict and severe drought, with cereal grain production down by half, livestock herds decimated, orchards and vineyards destroyed by war and drought, more than five million people displaced as refugees in neighboring countries, and remaining economic activities steered in an informal or illicit direction by insecurity and lack of support services. The Afghan state had become virtually non-functional in terms of policymaking and service delivery, although the structures and many staff remained.

6. Numerous people were suffering (and still are) from low food consumption, loss of assets, lack of social services, disabilities (e.g. from land-mine accidents), and disempowerment and insecurity. The effective Taliban ban on opium poppy cultivation, imposed in 2000, did not much affect trade in opium (apparently based on accumulated inventories) but was devastating to the livelihoods of many poor farmers and rural wage laborers, including through opium-related indebtedness. The collapse of the state virtually excluded the poor from access to services, and moreover the poor tended to be disproportionately affected by insecurity, one of whose important impacts has been a very large number of female-headed households. Even though the fabric of families, kinship groups, and other traditional clusters has held together rather well (demonstrated concretely by the large volume of inward remittances), the penetration of the “warlord” and “commander” culture at the local level has had deleterious effects. In sum, Afghanistan was essentially left out of the last 25 years of global development, with virtually no increase in per-capita income during this period and average life expectancy of only 43 years.

7. Afghanistan’s economy has performed very strongly in the past two years, with non-drug GDP increasing cumulatively by almost 50% (29% in 2002 and 16% in 2003), albeit starting from a very low base. This mainly reflects the recovery of agriculture from the drought, revival of economic activity after major conflict ended, and the initiation of reconstruction. With the improved political and economic situation, an estimated 2.4 million refugees have returned to Afghanistan, and 600,000 internally displaced people have returned to their homes. The last two years have also seen a rebound in opium production to near-record levels; the opium economy in 2003 comprised about a third of total drug-inclusive GDP and accounted for three-quarters of global illicit opium production.

8. Recent good growth performance has been supported by the Government’s sound macroeconomic policies – a highly successful currency reform in late 2002, a prudent “no-overdraft” policy prohibiting domestic financing of the budget deficit, conservative monetary policy which has brought inflation down to around 10% p.a., and good management of the exchange rate. Progress has also been made in mobilizing domestic revenue, which rose from negligible levels in 2001 to over 4% of GDP in 2003; in trade reform – import duties have been rationalized and customs administration reforms are underway; and in financial sector reform where the Central Bank has been made legally autonomous and several foreign banks have started up in Kabul.

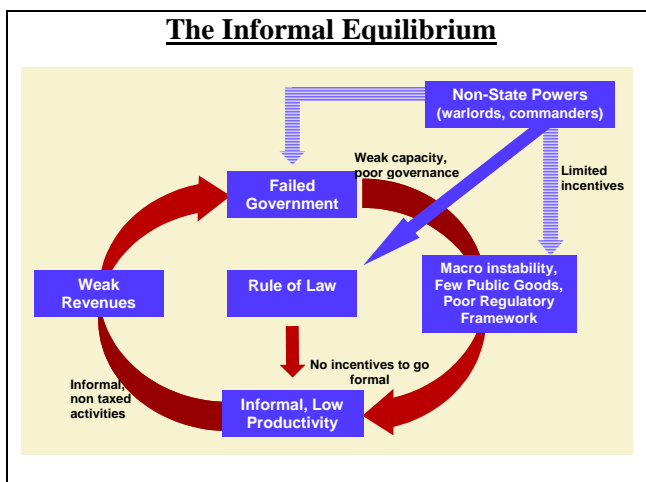
9. Peace and strong economic performance have been accompanied by improvements in some social indicators. Restoration and expansion of social services has been initiated, notably primary education and immunization. And the end of major conflict, combined with national programs like the National Solidarity Program (NSP), has enabled communities and other groups to begin building social capital. Despite this progress, Afghanistan remains a very poor country, with extremely low social indicators (e.g. infant mortality of 115 and under five mortality of 172 per 1,000 live births) and very low access to most public services (e.g. safe drinking water).

10. Although double-digit economic growth is expected to continue in 2004, the drivers of recent growth are to a considerable extent temporary and recovery-related (e.g. the boost in grain output) and are running their course. In order to achieve sustained rapid growth – necessary for poverty reduction, phasing out dependence on opium, and maintaining political buy-in for reforms – other, sustainable growth drivers will be needed. Afghanistan has areas of good potential for growth, ranging from agricultural production and processing to mining, construction, trade, and other services. Exploiting Afghanistan’s geographical position as a “land-bridge” between Central and South Asia also can be a source of growth – through trade, transit, and sharing and joint development of resources. Enhancing the role of women in economic life will help ensure that growth is broad-based.

11. For these and other growth potentials to be realized, however, the Afghan economy will need to move beyond its present, largely “informal” character. The informal economy, which includes a range of activities in terms of legality and market orientation and accounts for some 80-90% of the total economy (including drugs), has been a coping mechanism for Afghans’ survival during conflict and has shown considerable dynamism. It is flexible in responding to shocks and to short-term opportunities. But on the other hand, the informal economy is the outcome of conflict-related insecurity, short time horizons, erosion of rule of law, and lack of public services, which have influenced entrepreneurs’ decisions toward staying informal, relatively small, and not making longer-term investments. The dominance of the informal economy is a self-reinforcing equilibrium which not only keeps most economic activity informal but also hinders revenue mobilization, state-building, security, and ultimately competitiveness and growth (see Figure below).

TOWARD SUSTAINED GROWTH AND POVERTY REDUCTION

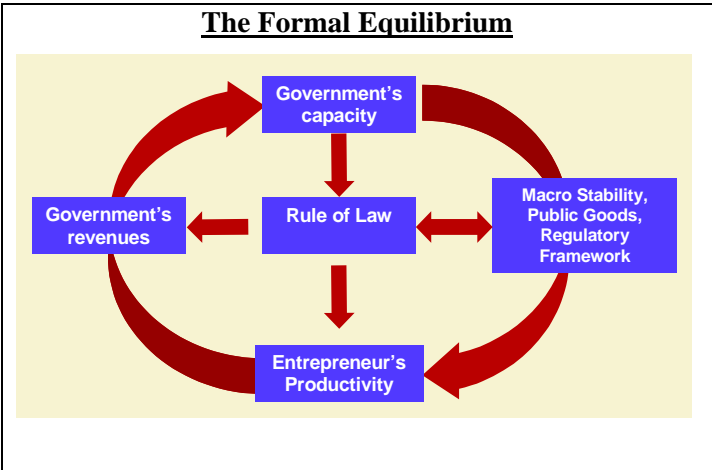
12. The Government’s SAF report puts forward an ambitious goal of 9% p.a. growth of non-opium GDP over the next 12 years, which is argued to be necessary for sustained progress in political normalization, state-building, poverty reduction, and phasing out the drug economy. The SAF report is equally ambitious in targeting sharp improvements in social indicators, in line with the Millennium Development Goals. For example, the gross primary school enrollment rate is targeted to rise from 54% (40% for girls) at present to 100% for boys and girls by 2015, the under-five mortality rate to decline from 172 to 130 per 1,000 live births, the infant mortality rate from 115 to 55 per 1,000 live births, and the maternal mortality rate from an estimated 1,600 per 100,000 live births to 205. These long-term objectives constitute major challenges for the Afghan Government, the Afghan people, and the international community in support.



13. Afghanistan faces some major constraints in sustaining recent rapid economic growth, which will have to be led by a strong, competitive private sector: (i) insecurity and lack of rule of law (fueled by the drug industry, which has a strong interest in maintaining an environment of insecurity and lawlessness); (ii) regulatory burden and corruption – although the Government has a pro-private sector policy orientation and has pursued trade and tax reforms, there is still excessive red tape in obtaining permits, land allocations, and the like; (iii) unavailability of key support services for the private sector, ranging from essential infrastructure (power – extremely important

for many types of activities, roads, serviced land, water) to finance, insurance, business support services, agricultural extension and marketing, etc.; and (iv) lack of a framework and infrastructure for standards, quality assurance, measures, testing, etc., which will be critical for export development. These constraints all fall within the general rubric of the “investment climate”. In addition growth will be constrained by (v) human capital, both extremely scarce managerial and technical professionals – decimated by conflict-related “brain drain” and lack of a credible higher education system in recent years – and literate, skilled labor to work in manufacturing and services; and, related, (vi) weak capacity of the private sector itself, which despite its strong and vibrant entrepreneurship within the informal setting lacks capacity and experience in competitively bidding on international contracts, producing to international export quality standards, and other requirements for longer-term dynamism and competitiveness.

14. Afghanistan’s growth strategy must be multi-faceted to ease these constraints and enable the Afghan private sector to generate broad-based economic activity and robust growth on a competitive basis (including competitiveness in exports, whose growth will be essential over the longer term to replace the eventual decline in external assistance). Sustained economic growth will be associated with breaking out of the “informal equilibrium” and moving toward a “formal equilibrium” whereby over time many successful and growing entrepreneurs become part of the formal economy – investing, registering themselves, paying taxes, and benefiting from rule of law and availability of services (see Figure). This does not mean that the entire economy would become formalized, let alone quickly, but rather that a sizable, dynamic formal sector would come into being. A strategy to shift incentives toward the formal equilibrium, building on the Government’s NDF, would have four key elements:



(i) improved security through fair and effective enforcement of law and order; (ii) maintaining macroeconomic stability; (iii) effective delivery of support services (such as power, infrastructure, and finance, and essential public goods in support of smallholder agriculture) and building the capacity of the private sector; and (iv) creation of an enabling regulatory environment for business activity through structural reforms. Progress has already been made most notably in trade and financial sector reforms, and macroeconomic stability has been achieved and will need to be maintained. Structural reforms will need to focus on completing those underway, on further deregulation to ease the burden of red tape and reduce vulnerability to corruption, and on new areas such as the privatization agenda. Progress in improving security and public service delivery will be crucial and will depend very much on gains in state-building. Over the longer term, human resource development will be essential, requiring priority investments in education and health, focusing on quality as well as access.

15. In the short run, rapid economic growth can be supported, and the process of “formalization” jump-started, by:

- i. **Importing resources**, including (i) aid and technical assistance, and military and police assistance; (ii) imports of goods and services; (iii) foreign direct investment; and (iv) ideas, capital, and skills from Afghans living abroad. To help promote the “formal equilibrium”, external assistance going through budget channels should be maximized, contracts awarded through transparent competitive bidding, and good fiduciary practices followed. Domestic

capacity building needs to be an integral part of this approach. Regional resources can support this effort, e.g. importing electricity and skilled workforce.

- ii. **Harnessing the dynamism of the informal sector** to generate growth, by (i) facilitating further growth of the informal sector, to the extent that it is legitimate – e.g. through micro-credit, targeting women who account for a large part of the informal sector, stimulating smallholder agriculture, developing cooperation among informal actors; and (ii) gradually shifting informal activities to the formal sector – through expanding linkages between formal and informal sectors, using donor-supported programs as a vehicle for contractors and implementation partners to move into the formal sector, encouraging small concerns to “come into the open” by exempting them from taxes, and putting in place a mining law, NGO regulatory framework, etc.
- iii. **Starting reforms in specific localities** (Industrial Parks, Export Processing Zones, Urban Enterprise Zones, etc.), where land, security, power, and enabling regulations may be easier to provide; the Government has already initiated development of Industrial Parks.

16. Economic growth will increase opportunities for poor people – by helping them to build their assets, through their investing (and repaying debts) from their own incomes, and accumulating physical capital like livestock. Increasing opportunities for poor people will also require building their human capital, developing community asset-building programs, financing assets through micro-credit, etc. Enhancing the economic role of women will support both broad-based growth and poverty reduction. To empower poor people, these approaches need to be complemented with the development of participatory institutions (e.g. the elected Community Development Councils established through the NSP). Finally, poor people should benefit from security improvements. Thus in addition to growth, main elements of a poverty reduction strategy would include:

- i. **Asset building on the part of the poor**, supported by a range of well-targeted, cost-effective programs, some of which like micro-finance and agricultural development programs would support both growth and poverty reduction. Public works employment programs and other income generation programs can help the poor preserve and over time build physical assets.
- ii. **Human capital building by the poor**, primarily through adequate levels and quality of basic education and health services (see Chapter 8 and, for details of expenditure requirements, the SAF report).
- iii. **Social protection** (see Chapter 9) is another key element of the poverty reduction strategy – in particular safety net programs for the extreme poor and those unable for various reasons (remoteness, disability, female-headed households, etc.) to fully take advantage of opportunities created by economic growth.
- iv. A final key element of a poverty reduction strategy is **consultation**. A good poverty reduction strategy needs to be “owned” by the poor as well as by other stakeholders. The Government is appropriately planning to engage in extensive consultations with different segments of the society as it develops its Poverty Reduction Strategy, a process that is targeted to reach a first stage of completion with the preparation of an Interim Poverty Reduction Strategy (I-PRSP) early in 2005.

17. Enhancing trade, both within the region and globally, will be vital to the expansion of market opportunities, and therefore for growth and poverty reduction. Capitalizing on Afghanistan’s position as a “land bridge” for trading within the region, and promoting its wider integration in the formal global economy, will require continuing policy and institutional reforms, with emphasis on trade facilitation. Afghanistan has already made significant progress in reforming its trade and investment regime. Nevertheless, official regional trade flows between Afghanistan and its neighbors remain relatively small, comprising only 11% of all exports in 2002, the rest being traded globally (World Bank, 2002). Informal trade flows with Pakistan and other countries are quite considerable however. Currently, trade logistics remain very difficult and costly, in a difficult

security environment that encourages informal and illicit trading patterns. Hence streamlining Afghanistan's transit links with both regional and non-regional trading partners would reduce transport-related trade costs and facilitate the growth of economic activity and incomes in Afghanistan and its neighbors. Problems of market access depend not only on formal trade barriers but also on barriers to efficient trade logistics and weaknesses in the operation of market institutions. The implementation of the newly approved tariff schedule as well as enhancing the capacity of the customs service, harmonizing customs procedures, and improving customs valuation, are all vital aspects of enhanced trade facilitation. Given its potential significance, regional trade deserves special attention in bilateral discussions and multilateral fora, such as the Economic Cooperation Organization (ECO), which along with Afghanistan and its neighbors includes Azerbaijan, Kazakhstan, Kyrgyz Republic, and Turkey. The March 2004 ECO Conference held in Kabul demonstrated a closer relationship between Afghanistan and other ECO members.

BUILDING AN EFFECTIVE, ACCOUNTABLE AFGHAN STATE

18. State-building forms the centerpiece of Afghanistan's reconstruction. The Government's development vision requires an effective central government that re-establishes the national unity of the country on the basis of government monopoly over the legitimate use of force, strong institutions, and rule of law. The SAF report laid out several specific goals in this regard: (i) **a well functioning and well-structured security sector**, based on institutions that facilitate a return to normalcy in the political, economic, and social spheres; (ii) **an effective public administration** that is small and focused on core functions, more diverse and decentralized, better skilled, equipped and managed, more accountable, and more representative in terms of gender and ethnicity; and (iii) **a budget that is affordable and sustainable on a multi-year basis** and enables delegation of authority based on strong accountability mechanisms.

19. When the post-Taliban government came into power, it found a public administration (inherited from the pre-war period) that was highly centralized in terms of its structure on paper, but which was denuded of infrastructure, human capacity, and financial resources, and had non-existent or very weak ties with the provinces. The bulk of revenues had been "captured" by illegitimate regional authorities, and service delivery for the most part had ceased or was handled outside government channels by NGOs. Much progress has been made since then: (i) macro control over the size of the civil service has been maintained; (ii) the national budget process has been reinstated, with the budget as the central instrument of policy and aid management; (iii) improvements in fiduciary management (procurement, financial management, audit) are increasing the Government's effectiveness and accountability in using public resources; (iv) civil service reforms are moving forward through the Priority Restructuring and Reform (PRR) process, under which core departments can reorganize themselves, build capacity, and pay qualified staff higher salaries; (v) a cabinet rationalization is being considered to reduce the number of Ministries; and (vi) a start has been made with security sector reform, although security has deteriorated in many areas.

20. Government faces a twin challenge: it must be fully in charge of running the state – capable of both making policy and implementing it throughout the country, but on the other hand it must not overstate its ability, and should limit its policy ambitions to its limited though growing capacity. Success will depend to a large degree on whether the Government can regain control over national policies and implementation across the country. This is made more difficult by the financial and military strength of regional warlords and local commanders. In this regard, security sector reforms have lagged far behind what is required, and the extremely limited international security assistance outside Kabul has not been helpful. Greater attention to improving security is key to progress in state-building and reconstruction. The massive amounts of donor aid largely provided off-budget, which dwarf Government budgetary resources, and the associated existence of a large and well-paid

“second civil service” consisting of consultants, advisors, and employees of UN and other international agencies and NGOs, comprise a second major hindrance to state-building.

21. The way forward in state-building involves continuing and deepening reforms that are underway, notably public administration reforms, fiscal management improvements, and revenue mobilization; and developing momentum in other areas, including security sector reform and reducing vulnerability to corruption. The ongoing political normalization process will be crucial. Donors’ support for state-building needs to include reducing reliance on the “second civil service” and maximizing direct budget support relative to other financing modalities.

ENCOURAGING AND SUPPORTING PRIVATE SECTOR DEVELOPMENT

22. As seen above, the Afghan private sector is at the heart of the country’s growth prospects and strategy but faces some difficult constraints. The Government has been pursuing pro-private sector policies in recognition that a sound investment climate is essential for private sector development. Nevertheless there is still much to be done to improve security, ease the regulatory burden, curb corruption, and make available necessary inputs (land, finance, infrastructure, skills). The legal framework for the private sector (revised investment law, company law, etc.) will be critical. Initiatives are underway for investment promotion through “one-stop shop” and Industrial Parks. Of particular importance will be Government financing of “public goods” in support of private sector growth and competitiveness, for example a metrology, standards, testing, and quality (MSTQ) system, and international market information and other export promotion services. Risk mitigation (for example through MIGA) and development of the insurance industry are important ingredients of a sound investment climate as well. The private sector also very much needs capacity building and business support services, which can be provided by the private sector itself but with active Government support and, where necessary, financing.

23. Infrastructure and finance will be key inputs for private sector development. While the legal framework for the financial sector has been liberalized and entry of foreign private banks has occurred, the provision of formal financial services in Afghanistan (such as credit) is still at a nascent phase and needs to be developed. At the small-scale end of the enterprise spectrum, micro-finance is being developed through the Micro-Finance Support Facility of Afghanistan (MISFA), and this could lead over time to commercially-oriented financial services to small businesses. In the case of infrastructure (notably roads, irrigation, power, water, and airports), massive investments will be required as detailed in the SAF report. It is of critical importance that appropriate institutional frameworks, accountability mechanisms, incentives, and financing for these services be put in place to ensure further expansion and sustainability as donor assistance eventually phases out. This means, in the case of public utilities, separation of the service provider from the Government and operation of the facilities concerned on an autonomous, commercially-oriented basis. In this regard, cost recovery (either direct or through indirect mechanisms like a road fund) will be necessary, not only for fiscal sustainability but also to improve incentives and enhance accountability (lifeline tariffs for the most poor should be utilized where appropriate).

AGRICULTURAL DEVELOPMENT PRIORITIES AND PROSPECTS

24. Agriculture, half the Afghan economy, is critical for future growth, poverty reduction, and export development. Maintaining robust agricultural growth requires adequate investments and a sound enabling environment. Key priority areas include the following:

- i. **Irrigation:** The Government’s emphasis on rehabilitation of surface irrigation facilities and subsequently major new investments is appropriate, but early attention is needed to ensure that water user groups fully participate in O&M and financing of O&M. This will require: (i) an appropriate legal framework; (ii) involving water user groups (WUGs) early

- in rehabilitation/development works, ideally from the design stage; and (iii) developing cost estimates of annual O&M requirements and discussing them with WUGs.
- ii. **Agricultural research and extension:** Dissemination of improved agricultural techniques and management practices will be essential to realize the full benefits of irrigation and other investments. Afghanistan needs to focus on adaptive research which must be demand-driven. Public and private sector roles in extension need to be clearly defined, extension services contracted out wherever possible, participatory and community-based approaches adopted, and extension focused on marketing not just production.
 - iii. **Marketing:** Investments in both “hardware” (market facilities, cold storages – requiring electric power, roads, etc.) and “software” (grades and quality standards, market research, standards for wholesale markets, market management by market players) will be very important.
 - iv. **Rural credit:** Micro-finance supported by MISFA is an important initiative underway. However, over the medium term additional forms of private, deposit-taking, and commercially-oriented rural credit will need to develop (e.g. through contract farming and similar arrangements).
 - v. **Land tenure** issues are widely considered to be a source of insecurity and problems for agriculture. Such issues are part of the larger governance agenda and can be complex and controversial to resolve, so it would be prudent for the Government to proceed by learning by doing through pilots and involving local communities, before scaling up.

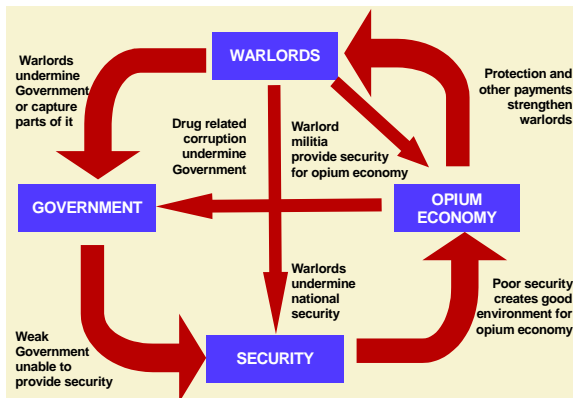
UNDERSTANDING AND RESPONDING TO THE OPIUM ECONOMY

25. Starting from a tiny base in the late 1970s, opium has become Afghanistan’s leading economic activity. Opium production (measured at farm-gate prices) generated around one-sixth of total national income in 2003, and downstream trading and processing of opium into opiates generated an even greater amount of income in-country. The impact of the drug industry on Afghanistan’s economy, polity, and society is profound, including some short-run economic benefits for the rural population and macro-economy but major adverse effects on security, political normalization, regional relations, and state-building. Responding effectively to the drug economy will therefore be essential for Afghanistan’s future development.

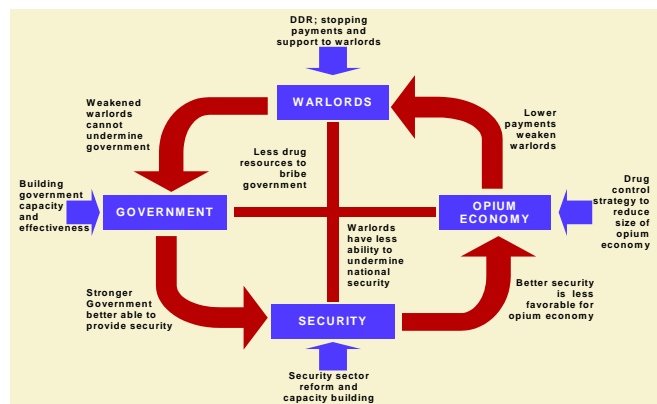
26. The opium economy is the lynchpin of a “vicious circle” of insecurity, weak government, powerful warlords, and drug money (see Figure below left) – part of the “informal equilibrium” – which will become increasingly entrenched over time if nothing is done. The drug industry has a strong interest in preventing the emergence of an effective, accountable state and thus is highly inimical to the state-building agenda. It has enormous financial resources to bring to bear against state-building, allies or “sponsors” in the form of warlords with military assets, increasingly entrenched ties with the rural economy, and significant penetration at all levels of government. There is also evidence of linkages between drug money and terrorist networks.

27. There are no easy answers to this problem, since international experience and Afghanistan’s own experience in fighting drugs have been largely unsuccessful, and moreover there is no precedent of such a large drug industry in relation to national GDP, thriving in an environment of poor security, weak government, and deep poverty. To have any hope of success, a multi-pronged approach is essential, addressing each of the key elements of the vicious circle associated with the opium economy – warlords (stopping payments to them, DDR, etc.), insecurity (security sector reform), and weak government (state-building, public administration reforms, revenue mobilization), as well as measures related to the drug industry itself (see Figure below right).

A Vicious Circle



Strategic Framework for Breaking the Vicious Circle



28. Experience also suggests that no single instrument of drug control alone will work well. It is the combination, timing, and sequencing of different instruments (eradication of poppy fields, interdiction of drug trafficking and processing, alternative livelihoods for poppy farmers and wage laborers) that will have better prospects of being effective. Phasing out opium production in Afghanistan will be a long-term effort requiring sustained commitment from the Government and international partners. While this report does not make hard-and-fast recommendations with respect to this extremely difficult area, some key considerations include:

- i. Balancing economic measures and law enforcement. Both are essential – and coordinated international involvement will most likely be required for effective law enforcement. Careful balancing with development programs is needed, taking account of incentives and sequencing issues. The Government may want to initially give priority to interdiction over eradication, as trying to do both equally would disperse scant political capital, energy, and capacity. Alternative livelihoods programs, and more generally measures to promote broad-based economic growth and employment generation, could be put in place, with the threat of law enforcement measures to follow. Eradication could then occur once there are credible alternatives and implementation capacity and political support are mobilized.
- ii. Prioritization, monitoring, and evaluation. Capacity and budget constraints make prioritization essential. Giving priority to action against larger participants in the drug industry would seem to be the most cost-effective approach. A focus on new areas with little or no history of poppy cultivation could make sense. Good monitoring will be needed of implementation, based on understanding the socio-economic situation of stakeholders.
- iii. Law enforcement capability. Clarifying institutional responsibilities and enhancing capacities with respect to law enforcement remain a priority.
- iv. Legal framework and judicial and penal process. The justice system needs strengthening.
- v. Need for international and regional support. The Government is seeking sustained support and cooperation in its efforts against drugs, and in controlling the trade in both transit and consuming countries, both internationally and regionally.

DELIVERING BASIC SOCIAL SERVICES AND PROMOTING GENDER EQUITY

29. Delivery of basic social services – elementary education, basic health services, and water supply and sanitation – to the poor, especially to women and girls, will be a major determinant of Afghanistan’s longer-term growth and success in poverty reduction. The country inherited a highly centralized system of government social service provision, which reached only a small proportion of the population (mainly the urban elite) and was devastated during the war. Key issues associated with this system include, in addition to narrow coverage and problematic quality: (i) limited human

resource capacity in Afghanistan; (ii) lack of financial resources especially for O&M; (iii) de jure centralized service delivery structures and mind-sets; (iv) de facto local political autonomy; (v) lack of information and monitoring; (vi) disconnect with households and communities; and (vii) sustainability issues related to heavy reliance on donor funding.

30. Getting institutional relationships and incentives right for different actors (service providers, government, and service recipients), so there is meaningful accountability for performance, will be essential for effective social service delivery. In the case of education, schools (the units directly responsible for service delivery) need to be given a greater role in day-to-day management of their activities while enhancing their accountability to beneficiaries through community monitoring (perhaps through the elected Community Development Councils under the NSP). In the case of health, competitive, performance-based contracting of non-government providers is being implemented in a third of Afghanistan's provinces, strengthening accountability of providers to the Government. In both education and health, oversight of service providers needs to be de-concentrated from the center to the provincial level, and in the case of urban water supply to the municipal level. However, central oversight particularly of contracting would need to be maintained in the case of provinces that have been "captured" by regional powerbrokers.

ASSISTING THE POOR AND VULNERABLE

31. An affordable, well-targeted social protection strategy is needed to provide a safety net for poor and vulnerable Afghans who are unable to fully benefit from economic growth. Income generation and skill development are the Government's preferred vehicles for support, with pure transfers reserved for a minimal safety net for those unable to benefit from other programs. Existing social protection programs, notably the National Emergency Employment Program (NEEP) and other employment programs, while successful in many respects, appear not to be very well-targeted toward the poorest and most vulnerable members of the rural population. While there was a need to inject incomes into the rural economy during the drought, as there may be in the future, and targeting is understandably difficult given low levels of income in most rural households and local social pressures, NEEP and other similar programs need to clarify their objectives and explore ways of improving targeting of the poor.

32. More generally, the Government is developing a holistic social policy including a National Vulnerability Program. Many of the elements of good policy are already in place. In the near term the key is to ensure that the main national programs are effectively implemented, with monitoring and evaluation providing insights for improved design. It will be necessary to increasingly move beyond a fragmented project-driven approach to a systematic national program.

CONCLUSIONS

33. The challenge that Afghanistan, with support from international partners, faces – to rebuild the state, improve security, sustain rapid, broad-based economic growth, and reduce poverty – is both complex and risk laden. In the short term, the priority is to implement policy and institutional reforms already under way, focusing on the most inclusive measures that contribute to building the nation. Among the areas for action set forth in the table below, a number of key priorities stand out:

- i. **Enhance Security and Rule of Law, Respond to Drugs in a Coordinated Manner:** The continued existence of warlords and forces disloyal to the national government, funded in large part by drug money, undermines state-building and other reconstruction agendas. Security sector reforms need to be given top priority, and administrative reforms in the Ministries of Defense, Interior, and Justice need to be accelerated. The Afghanistan Stabilization Program (ASP) will need to support improved governance of security in provinces and districts. There are no easy answers on drugs, but it is clear that actions

against the opium economy must be integrated within broader national objectives and particularly the security and state-building agenda in order to have any hope of success. The recent establishment of a Counter Narcotics Steering Group, chaired by the Government and including the main domestic and external agencies, is encouraging.

- ii. **Pursue Political Normalization:** The upcoming elections will mark the completion of the political process mandated by the Bonn Agreement, but there is still a long way to go in political normalization. The key priority will be making Afghanistan's nascent political institutions – ranging from the new Cabinet to the new elected legislative bodies and the judiciary – fully functional and effective so they can handle their Constitutionally-mandated roles. Full implementation of the security-related provisions of the Bonn Agreement, including demilitarization of Kabul, will facilitate political normalization.
- iii. **Maintain Growth with Macroeconomic Stability:** This is essential but will face risks – drought, political instability, “poppy shock”, “Dutch disease”, etc. – as well as other challenges (e.g. fiscal pressures, limited private sector supply response). The Government will need to monitor economic performance closely, making adjustments in response to shocks, while enhancing analytical capacity and macroeconomic policy instruments.
- iv. **Intensify Public Administration Reforms with Extension to the Provinces:** As a critical part of the state-building agenda, the Government will need to continue and accelerate current administrative and civil service reforms, including implementation of the PRR process, increasing revenue mobilization, and reducing vulnerability to corruption. It will be especially important to enable provinces to better interface with the public and deliver services, by ensuring timely payments of their employees and access to their non-salary budgets, strengthening their capacity through the ASP, and other similar initiatives.
- v. **Accelerate Private Sector Development, Including Agriculture:** Priority should be given to implementation of ongoing reforms: adoption of key laws (Investment, Mining, Petroleum), acceleration of micro-credit schemes, and development of Industrial Parks. Irrigation, marketing, credit, and extension services need to be efficiently provided to Afghan farmers, relying on the private sector as much as possible to provide these services.
- vi. **Poverty Reduction, Gender, and Social Protection:** The effectiveness of a poverty reduction strategy will largely depend on national ownership – requiring more extensive consultations with different stakeholders than has occurred hitherto. Enhancing the role of women requires addressing some of their main concerns, such as poor access to education, basic health services, and credit. Building on experience, existing programs need to be improved to effectively target them to the poorest.

Main Areas	Priority Actions
For the Government	
Security and Rule of Law (Chapters 3 and 4)	(i) Implement security sector reform and build up well-trained, disciplined security forces (national police, national army) under the control of the national government; (ii) vigorously pursue DDR to meaningfully disarm warlords' militias; (iii) strengthen legal and judicial system; and (iv) improve security of property rights, building on existing informal arrangements.
Macroeconomic Policies (Chapters 1 and 3)	(i) Maintain conservative macro-policy mix with light exchange rate management; (ii) monitor sources of macro risk and stand ready to intervene in face of major shocks to maintain robust, broad-based economic growth.
Budget Management (Chapter 4)	(i) Increase domestic revenues (customs, simplify income tax code); (ii) prepare, approve, and execute budget in timely manner; (iii) strengthen integration of ordinary and development budgets, linkages between policies and budget; and (iv) adopt and implement Procurement, Public Expenditure and Finance Management, and Audit Laws to enhance accountability and reduce vulnerability to corruption.
Public Administration (Chapter 4)	(i) Implement PRR program and avoid pay increases outside PRR; (ii) inject capacity on short term contracts for key positions; (iii) rationalize number of ministries, with clear portfolios; (iv) implement Afghanistan Stabilization Program; (v) strengthen financial management in municipal governments; and (vi) enhance accountability and reduce vulnerability to corruption (e.g. through civil service law).
Public Service Delivery (Chapters 4, 5, 8)	(i) Expand access to elementary education (and improve quality), and to basic health services; (ii) give service facilities (schools, clinics) greater role in day-to-day management, with government oversight de-concentrated to provincial level; (iii) promote client monitoring and greater accountability of service providers to clients; (iv) separate public utilities (power, water) from government, with management and operations on commercial, financially sustainable basis; and (v) use cost-recovery to enhance both accountability and fiscal sustainability.
Regulatory Framework (Chapters 3 and 5)	(i) Develop and implement reform of state-owned enterprises; (ii) adopt revised Investment Law and reform legal framework, finalize mining, petroleum, and other sector-specific laws; and (iii) continue to pursue structural reforms in trade/customs, financial sector, and taxation.
Support Services (Chapters 3, 5, 8)	(i) Develop Industrial Parks with adequate regulatory framework and private sector participation; (ii) accelerate implementation of micro-credit schemes (MISFA), with particular focus on women; (iii) implement infrastructure investment program, especially power, roads, and irrigation; (iv) develop a metrology, standards, testing, and quality (MSTQ) system; (v) implement political risk guarantee facility and liberalize insurance sector; and (vi) promote the transformation of the Export Promotion Department of the Ministry of Commerce into an independent agency with high-quality staff.
Agriculture (Chapter 6)	(i) Put in place appropriate legal framework and financing mechanisms, in partnership with water user groups, to guarantee proper O&M of irrigation schemes; (ii) develop public-private partnership-based research and extension systems to disseminate improved agricultural techniques and management practices; and (iii) develop grades and standards, market research, minimum standards for wholesale markets, market management by market players.
Opium economy (Chapter 7)	(i) Take fully into account macroeconomic and poverty impacts of actions against drugs; (ii) mainstream drug policy within broader strategic framework for state-building, security, political normalization, reconstruction, and growth; and (iii) avoid premature, single-dimension measures that will encourage a shift of production to other parts of the country or will not be sustainable.
Social Protection (Chapter 9)	(i) Adjust existing programs for greater effectiveness toward clarified objectives (targeting poorest, injecting income in face of shocks, or asset-building); (ii) develop well-targeted National Vulnerability Program to provide minimal safety net to those unable to benefit from growth or other programs.
Gender	(i) Develop monitoring mechanisms for public sector employment of women; (ii) favor female employment in social services to increase service delivery to girls/women.
For the International / Donor Community	
Financial Assistance (Chapters 3 and 4)	(i) Maximize assistance through Budget and Treasury and move toward programmatic support; (ii) commit assistance at beginning of or early in fiscal year to facilitate Government budget management; and (iii) be prepared to respond to macroeconomic shocks (e.g. by accelerating and adjusting assistance) to help maintain aggregate demand and growth.
Technical Assistance (Chapter 4)	(i) Ensure that all TA responds to national priorities and is under Government leadership and control (consultants reporting to Government with approved TORs); (ii) maximize use of coordinated TA mechanisms; and (iii) coordinate with Government on pay policies for consultants.
Other (Chapters 4 and 7)	(i) Work with Government to support implementation of reconstruction program; (ii) support security sector reform, including through international security assistance outside Kabul; and (iii) ensure that actions against drugs occur within the framework of the Government's strategy and leadership, and mindful of the broader economic and poverty context (iv), enhance alignment of donor priorities to the national budget and (v) improve donor coordination within and across sectors.