Afghanistan Analysts Network

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Economic Management in Afghanistan

What Worked, What Didn't, And Why?

1. INTRODUCTION

Afghanistan has not only been undergoing challenging political and security transitions, the country currently also faces daunting economic problems, including very slow growth, high unemployment, weak private investment, and anaemic government revenues. The 2014 presidential election – Afghanistan's first without an incumbent on the ballot – led to a prolonged and difficult political transition to a new administration. This political change was juxtaposed with the transfer of combat responsibilities to the Afghan National Security Forces (ANSF) as the US and other international partners drew down their military forces in 2014. The National Unity Government (NUG), in addition to the serious political challenges it faces, has to deal with a very weak economy and a continuing fiscal crisis.[1] Although the NUG agreement[2] as well as the government's paper for the London Conference[3] in December 2014 embody some strong policy statements and a general determination to move ahead, the complex formal political arrangements of the NUG are likely to be an obstacle to reforms, and challenges with day-to-day political management are apparent. Moreover, the NUG agreement's political agenda is dauntingly ambitious and likely to prove contentious, further absorbing political attention. Nevertheless, the economy and especially the fiscal situation will continue to demand attention and indeed, if things get worse, could have political ramifications. In this light, looking back at the experience with economic management since 2001 and gauging the relevance

[1] On the currently very weak economy, see the World Bank's recent *Afghanistan Economic Update April 2015,* http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2015/05/15/090224b082e8582d/2_0/Rendered/PDF/Afghanistan0economic0update.pdf; on the fiscal crisis, see William A. Byrd, "Afghanistan's Continuing Fiscal Crisis: No End in Sight," US Institute of Peace *PeaceBrief* no. 185 (May 2015), available at http://www.usip.org/sites/default/files/PB185-Afghanistans-Continuing-Fiscal-Crisis-No-End-In-Sight.pdf.

[2] National Unity Government deal text available at https://www.afghanistan-analysts.org/miscellaneous/aan-resources/the-government-of-national-unity-deal-full-text/.

[3] Ashraf Ghani, "Realizing Self-Reliance – Commitments to Reform and Renewed Partnership," paper presented at the London Conference in December 2014, http://www.afghanistan-un.org/wp-content/uploads/2014/12/REALIZING-FINAL-SELF-RELIANCE-25-November-2014.pdf.

of that experience for economic management in the current difficult situation makes sense.

Despite current economic difficulties, economic management – macroeconomic and public financial management in particular – has been one area in which major successes have been achieved in Afghanistan since 2001. Economic growth has been rapid (an average of over 9 per cent per year), average per-capita income has risen sharply, inflation has been contained, and the exchange rate has been relatively stable following the successful currency reform of 2002–03.[4] Afghanistan's international reserves are now equivalent to eight months of imports – a good cushion against external shocks that most other countries don't have. However, growth has not been inclusive following the early agricultural and post-conflict recovery. Consumption inequality slightly increased between 2007–08 and 2011–12, while inequality of income and especially wealth undoubtedly is much greater; moreover, despite rapid economic growth, the proportion of Afghanistan's population below the poverty line has not declined.[5]

Progress, moreover, has been variable over time, and within an overall positive picture, examples of failure have been evident. Backsliding has occurred in some respects in recent years, and some areas of progress show clear signs of a lack of sustainability.

During most of the period since 2001, Afghanistan's budgetary revenue has grown rapidly, peaking at 11.6 per cent of GDP in 2011–12 (higher than Pakistan's corresponding ratio and Iran's non-oil revenue to GDP ratio), but subsequently it has stagnated and even declined in nominal terms, dropping substantially to 8.4 per cent of GDP by 2014.

The sharp slowdown in economic growth, to 3.7 percent in 2013 and 2 percent in 2014, will likely continue in 2015. This slowdown is attributable in part to the reduction in international military expenditures with the drawdown of foreign troops, but also to uncertainty about the transition and loss of confidence over the long delay in signing the Bilateral Security Agreement (BSA) with the USA, the election process and its convoluted outcome, and the volatile security situation and outlook. The fact that overall economic growth during the past three years has been much lower despite good agricultural performance highlights the vulnerability of the economy to further shocks. A poor agricultural harvest, substantial worsening of the security situation, or a political breakdown could easily send economic growth into negative territory.

Afghanistan's experience with macroeconomic and public financial management since 2001 has yielded important lessons, some of which may be applicable to other spheres of activity in Afghanistan, as well as to other conflict-affected and post-conflict countries. This paper next discusses several of the most prominent cases of success in the macroeconomic and public financial management sphere, as well as some notable examples where progress was limited or where outright failure occurred. Then the main success factors that cut across individual cases are listed and summarised. The paper concludes with a discussion of limitations and current obstacles, some lessons from experience, and implications for economic management, currently and in the future.

2. PAST ECONOMIC MANAGEMENT SUCCESSES, AND SOME CONTRASTING FAILURES

Public Financial Management: Confluence of Incentives and Dynamics

Public financial management – which refers to the budgeting, allocation, spending, accounting, and auditing of public funds – is a foundation of government functionality, policymaking, and accountability. This has been an area of outstanding, sustained progress. Based on the Public Expenditure and Financial Accountability (PEFA)[6] assessment of the country's public financial management status as of the end of 2012, Afghanistan compares favourably with countries that in other respects are much better off and far exceeds other fragile or conflict-affected low-income countries (Figure 1). Public financial management improvements, and associated confidence that budget funds are being properly accounted for and are spent for stipulated purposes with credible financial controls, have

[4] For the broad economic picture and trends since 2001, see, among others, Richard Hogg, Claudia Nassif, Camilo Gomez Orsorio, William Byrd, and Andrew Beath, "Afghanistan in Transition: Looking beyond 2014" (Washington, DC: The World Bank, 2013), p 41. For more recent developments including with regard to inflation, exchange rate, foreign currency reserves, etc., see World Bank, *Afghanistan Economic Update April 2015* [see FN 1].

[5] See World Bank, *Poverty Status in Afghanistan*, July 2010; Afghanistan Central Statistics Organization, *National Risk and Vulnerability Assessment, 2011–2012*.

[6] See the details of the assessment at the PEFA website, available at https://www.pefa.org/en.

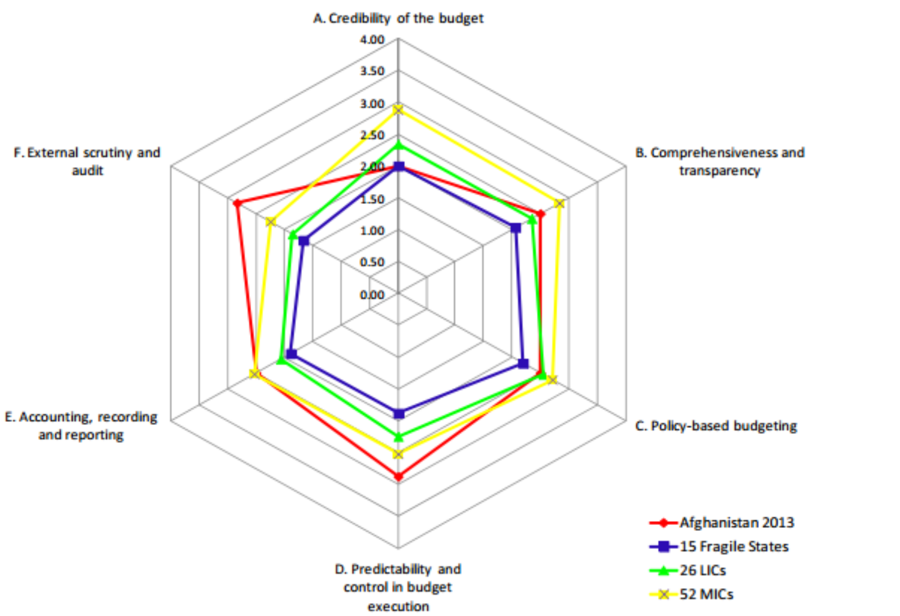
enabled large increases in aid channelled through the Afghan budget, as well as in total budgetary expenditures. Starting from very low levels in the early post-2001 period, total on-budget aid approached 15 per cent of GDP in 2013, with further increases expected as more security costs are shifted onto the budget. Moreover, non-projectised on-budget aid, consisting of funds that are not earmarked for specific development projects or programmes, over which the Afghan government has control within the parameters of its budget, approached 2 billion US Dollars (roughly 9 per cent of GDP) in 2013. This is an extraordinary achievement that would not have been possible in the absence of the major improvements in public financial management institutions, processes, and capacity that occurred.[7] While on-budget aid has comprised a relatively small proportion of total civilian and security sector aid to Afghanistan (total aid peaked at around 100 per cent of GDP in 2011–12 before dropping to below half that level in recent years), Afghanistan nevertheless has achieved extraordinarily high levels of on-budget aid in absolute terms compared to other post-conflict and conflict-affected countries.

The sustained progress in Afghanistan's public financial management was largely because incentives of key actors were mutually consistent and well aligned and the initial investments and actions set in motion dynamics that favoured increases in on-budget aid and public financial management improvements. Details are discussed in section three of this paper.

The 2002–03 Currency Reform: Not Listening to the IMF, Using Existing Informal Sector Capacity

After hyperinflation during the 1990s, by 2001 Afghanistan's currency was almost valueless, the largest note worth less than 0.25 US Dollars. The Afghan government, led by the minister of finance with the governor of the central bank (Da Afghanistan Bank – DAB), decided that a new currency was essential for national sovereignty and macroeconomic stability and went ahead with a currency reform despite initial advice from the IMF to go instead with dollarisation. Subsequently, international advice was to engage an expensive consulting firm to implement the currency reform, but the government decided to rely on the *hawala* (informal financial transfer) system instead to

Figure 1
PEFA Assessment of Afghanistan's Public Financial Management System (2012)



Source: World Bank, *Public Financial Management and Accountability Assessment,* August 2013, p 7, Graph 1, http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2013/11/19/000442464_20131119103203/Rendered/PDF/809960ESW0whit0EFA0Afgh020130Final.pdf.

[7] The figures on aid-to-GDP ratios can be found in World Bank, *Afghanistan Economic Update April 2015*, Annex 2, p 26, http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2015/04/27/090224b082e136e3/1_0/Rendered/PDF/Afghanistan0economic0update.pdf.

collect the old currency and exchange it for new notes.

This was inevitably a chaotic and messy process, not least since considerably more of the old currency appeared than had been thought to exist – the difficult decision was made to exchange this extra currency (some of which consisted of large amounts of brand new bills in shipping containers), even while recognising that doing so would provide a further windfall to the power-holders who had control over this currency. Inventory control and disposal of the enormous number of old notes posed logistical difficulties. Nevertheless, the currency reform was completed between October 2002 and January 2003. The new Afghan currency quickly built up credibility and provided a sound foundation for macroeconomic management. This is an example where success was achieved by the Afghan government charting its own path, making use of existing local capacity, and taking a practical approach in implementation rather than striving for illusory perfection.

The No-Overdraft Fiscal Rule: Right for Its Time and Feasible

The Afghan Ministry of Finance, in this case with full IMF support, early on instituted a strict policy of not resorting to domestic deficit financing, i.e., not borrowing from or running a negative deposit balance or 'overdraft' vis-a-vis DAB. This sent a welcome signal of fiscal self-restraint and buttressed the credibility of the Afghani. The no-overdraft policy was feasible during the post-2001 decade as levels of aid channelled through the Afghan budget and domestic revenues were rising rapidly. Once deposits with DAB were built up, managing cash flow within each year by drawing down or increasing DAB deposits was possible. Moreover, the usual trade-off – that fiscal tightness by reducing aggregate demand might lead to lower economic growth – was not operative, since the economy was in any case growing rapidly, fuelled first by the initial agricultural and post-conflict recovery and then by massive international military expenditures and very large amounts of aid.

Since around 2011 – in a recessionary economy with revenue stagnating, expenditure pressures worsening, international military spending falling sharply, and aid beginning to decline – the strict no-overdraft policy may have outlived its usefulness – in particular due to its likely dampening effect on aggregate demand in an already weakening economy. Indeed, in the past two years the government has incurred small domestically financed budget deficits by running down deposits at DAB, which it had built up in earlier years.[8] With those deposits now reduced to very low levels, continuance of such small deficits would require some form of borrowing or overdraft from DAB, which raises issues of fiscal discipline; running high deficits financed by borrowing from DAB would be problematic and easily could lead to hyperinflation. But whatever deficit policy may make sense now and in the future, the no-overdraft policy adopted and consistently implemented in the early post-2001 years certainly played a useful role.

Good Monetary and Foreign Exchange Management by DAB, but Weak Bank Supervision

Da Afghanistan Bank (DAB) presents a mixed picture: on the one hand, macroeconomic management, using rudimentary instruments (notably regular auctions of foreign currency in the Kabul market), has been effective in controlling the money supply and stabilising the foreign exchange rate, limiting inflation, and building up sizable foreign currency reserves. On the other hand, weak supervision of private banks has been a contributing factor to the massive fraud and theft amounting to close to 1 billion US Dollars in the politically connected Kabul Bank. How this happened, despite considerable development of capacity and processes in DAB, is discussed in Box 1. Perhaps most fundamentally, the Kabul Bank fiasco illustrates how a confluence of greed, readily available resources for looting, and high-level political connections protecting those involved gave rise to a 'perfect storm.' Other Afghan private banks, though much smaller than Kabul Bank, also carry vulnerabilities and risks of failure, albeit more due to concentrated and potentially bad investments rather than the kind of outright fraud and theft seen in Kabul Bank.

[8] A drawdown of positive deposits represents deficit financing in the year in which it occurs, and there is no difference conceptually and from a macro-monetary perspective between running down positive deposits by a certain amount and incurring an overdraft (ie, negative deposit balance) vis-à-vis the central bank of the same amount.

Box 1
Contributing Factors to the Kabul Bank Disaster

In post-2001 Afghanistan, the establishment of a number of Afghan private banks, based on a new banking law designed with international technical assistance, as well as the setting up in the country of branches of several foreign banks, were initially seen as one of the success stories. As information emerged in 2010 about the massive fraud and theft at Kabul Bank, however, it became clear that Kabul Bank constituted a serious threat to macroeconomic and fiscal stability, severely damaging the credibility of the Afghan government.

The full story and ramifications of the Kabul Bank crisis have been recounted in detail elsewhere, most notably in two publicly available reports by the Joint Monitoring and Evaluation Committee.* Enabling factors that contributed to this disaster include the following:

1) The combination of very high-level political connections and an aggressively expanding private bank with large and growing deposits (partly facilitated by Kabul Bank's role in handling payment of salaries into government employees' bank accounts) led to great vulnerability to politicised decision-making as well as serious risks of fraud and theft with political protection. Close associates and relatives of top political leaders serving as principals and shareholders was a fundamental contributing factor to the Kabul Bank crisis.
2) Technical assistance to and capacity building in DAB, though significant, was unable to offset these powerful political forces. Nor was having a good banking law on the books any kind of meaningful deterrent. By the time the huge extent of the losses became apparent, it was already too late to engage in prevention; recovering stolen funds subsequently has been an uphill battle.
3) The narrow institutional objectives and incentives of donors and international financial institutions (IFIs) were not closely aligned with the financial probity of Afghan private banks. In the first place, their own money was not directly at risk (although when the Afghan government had to step in and fill the "fiscal hole" created by the Kabul Bank failure, donor funds were indirectly affected given the fungibility of the budget). And for IFIs, hands-on oversight of private banks was not part of their mandate or normal business, unlike public financial management. Thus the international side had no strong institutional incentives to prevent the Kabul Bank disaster.
4) Finally, in retrospect the early focus on the restructuring and privatisation of Afghanistan's handful of public sector banks seems misplaced. These fairly small banks (most of them virtually defunct) did face management problems and posed potential fiscal risks, but nothing like Kabul Bank as its deposits grew to a peak of 1.3 billion US Dollars. Moreover, despite considerable efforts and associated conditionality, progress reforming the public sector banks was slow, while in the meantime Kabul Bank was incurring major systemic risks, resulting in a worst-case outcome.

Source: Author's analysis.

* See the Independent Joint Anti-Corruption Monitoring and Evaluation Committee reports "Report of the Public Inquiry into the Kabul Bank Crisis," 15 November 2012, http://www.mec.af/files/knpir-final.pdf, and "Unfinished Business: The Kabul Bank Follow-up Report," 2 October 2014, http://www.mec.af/files/2014_10_02_Kabul_Bank_Follow-Up_Report.pdf.

Government Capture of Customs Revenues – But Corruption Entrenched in the Customs Department

In late 2001, customs facilities at Afghanistan's border crossings were controlled by regional power-holders, who appropriated customs revenues, preventing them from accruing to the national budget. Recapturing customs revenues was an early priority for the Ministry of Finance (MoF), which accomplished this goal over several years through a combination of pressure, moral suasion, and in some cases removal of the power-holders concerned from their official positions and their transfer elsewhere. Once received and booked, customs revenues enter the government's single treasury account and became resources for the national budget with associated public financial management protections. This was a major accomplishment of the early post-2001 period, and contributed to the rapid growth of total budget revenues to a peak of 11.6 per cent of GDP in 2011–12.

Unfortunately, however, pervasive corruption within the MoF Customs Department has resulted in major losses of potential revenues. Although part of the decline in customs revenues since 2011–12 can be explained by the slowdown in economic growth and lower dutiable imports, a considerable part must also be due to corruption, as accounts (including by current and former customs officials) indicate that corruption in the department is organised and pervasive. The sheer volume of resources vulnerable to corruption, and the fact that customs duties are levied at a small number of border processing points and international airports, has made them an attractive target.

Challenges to Further Progress in Afghanistan's Public Financial Management

Further public financial management progress faces important challenges, as well as threats to past accomplishments:

- *Stagnation of revenue in nominal terms and sharp decline in its GDP share* – this has worsened the outlook for fiscal sustainability and may at some point undermine donor support for on-budget aid, not least if it is perceived that such aid reduces government incentives to mobilise more revenue.
- *Enormous availability of off-budget funds during the 'surge' period*, which may have diluted some of the positive incentives supporting public financial management improvements.
- *Significant ineligible expenditures submitted to the Afghanistan Reconstruction Trust Fund (ARTF) for reimbursement* – as much as 20 per cent of payroll and close to 60 per cent of non-wage operations and maintenance (O&M) in recent years have been found by the ARTF's external monitoring agent to be ineligible for reimbursement; this does not mean loss of donor money but is a sign of weakness in public financial management processes.[9]
- *Entrenched and pervasive corruption in general, which is having negative impacts* – though good public financial management practices have so far limited the vulnerability of budget spending to corruption.
- *Difficulties in making the Afghan budget a more strategic policy instrument* – which have been exacerbated by the fiscal squeeze during the past couple of years – with most budget resources tied to security, salaries, and specific donor-funded development projects, only a small discretionary portion is left.

3. INGREDIENTS OF SUCCESS IN AFGHANISTAN'S PUBLIC FINANCIAL MANAGEMENT

What were the ingredients of the sustained progress in public financial management described earlier in this paper? First, the incentives for key actors involved – the Afghan government (primarily the Ministry of Finance), the World Bank (administrator of the ARTF),[10] and bilateral donors – were mutually consistent and well aligned. Their narrow institutional objectives and the constraints they faced, though distinct, pushed them in the same direction, especially via the ARTF financing mechanism. The government wanted more funds to go through the Afghan budget, under its control, which was seen as critical not least for paying government employees' salaries at the beginning, which had been paid only intermittently during the 1994–2001 Taleban regime. The World Bank's objective of delivering substantial aid to Afghanistan (both its direct aid and assistance through the ARTF) required that such aid go through the budget and be executed by the Afghan government, as per the World Bank's institutional rules. Bilateral donors were interested in delivery of aid funds to further development and stabilisation priorities, but were reluctant to do so through the Afghan budget, reflecting fiduciary as well as legislative constraints in their capitals. The institutional objectives of all three main actors were served, and the constraints they faced were eased, by putting in place sound public financial management systems and making sure they worked adequately and improved over time. Initially, public financial management improvements occurred through buying-in foreign capacity to work for the Afghan government, but over time Afghan institutional and human capacity increased.[11]

[9] In earlier years, ineligible ratios of 10 per cent or less for payroll and below 40 per cent for non-wage O&M were typical. Since ineligible expenditures are not reimbursed by the ARTF, no ARTF funds (or associated donor contributions to ARTF) are lost as a result, but nevertheless high ineligibles can be an indicator of weakness in expenditure reporting and controls.

[10] The Afghanistan Reconstruction Trust Fund (ARTF), established in 2002, is a multi-donor coordinated financing mechanism that pools contributions of several dozen donors and channels them through the Afghan budget. The ARTF recurrent window pays for civilian government salaries and non-wage operating expenditures, while the ARTF development window funds development projects and programmes. For more details, see the ARTF website: http://www.artf.af.

[11] However, many professional and managerial Afghan staff in both MoF and elsewhere in the Afghan government have been on temporary contracts at much higher than civil service pay rates – raising important questions about sustainability.

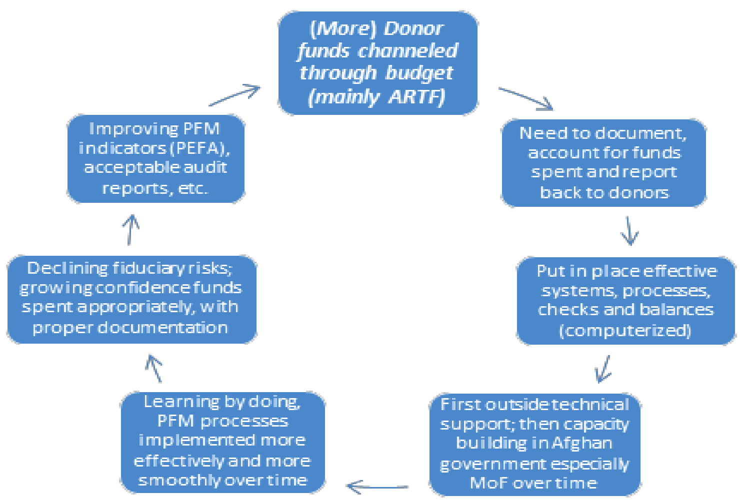
Second, financial enabling factors were instrumental in the ARTF's initial success and subsequent progress. The World Bank initiated a series of projects, starting as early as April 2002, to fund the development of public financial management systems and capacities in MoF. The World Bank also covered the initial start-up administrative costs of the ARTF. A pro-active risk-taking donor – the Netherlands – provided an up-front grant to the ARTF of 35 million Euros in 2002, which enabled the ARTF's start-up, along with contributions from the UK. And then other donors, with a generally supportive albeit more cautious attitude, started contributing to the ARTF in significant amounts, and eventually "flocking to success" became evident as ARTF contributions snowballed to very high levels.

Third, policy actions and sustained management attention were important. Public financial management reforms initially relied on Afghanistan's existing accounting system, which facilitated rapid uptake by government officials already familiar with that system, and on the existing legal framework dating mostly from around the 1960s. Later, when new laws were introduced, the centrepiece – the Public Finance and Expenditure Management Law – was tailored to Afghanistan's circumstances, needs, and not least legal terminology that was understandable in the national language. Senior officials in both MoF and the World Bank prioritised the ARTF, and the latter early on stationed senior financial management staff in Kabul who could provide hands-on support. Finally, key donors pro-actively supported the ARTF, participating in the ARTF steering committee, conducting reviews and demanding adequate financial controls, reporting, and accountability.

Beyond the incentives and the initial investments and actions by key actors involved, strong dynamics in favour of increases in on-budget aid and further public financial management improvements over time were set in motion. Aid money channelled through the national budget via the ARTF entailed requirements for documentation and accounting of funds spent, which in turn meant that effective public financial management systems, processes, and checks and balances had to be put in place. Learning by doing was a big part of the story in the early post-2001 years, leading to better public financial management implementation, declining fiduciary risks, improving public financial management indicators, acceptable audit reports, etc.

As illustrated in Figure 2, progressive improvements in public financial management and increasing on-budget aid (mainly through the ARTF) reinforced each other, leading to positive results on both fronts over a decade and longer. All this increased confidence that on-budget funds were being spent well and fiduciary risks contained, which encouraged donors to provide more funding through the ARTF, building a virtuous cycle. In addition to serving the more narrow institutional objectives of the main actors, this virtuous cycle more importantly delivered progressive improvements in public financial management processes and outcomes (as demonstrated by PEFA indicators for 2005, 2008

Figure 2
Dynamics of On-Budget Aid, ARTF, and Public Financial Management Improvements



Source: Author.

and 2012), as well as positive development outcomes for national programmes supported by the ARTF and other on-budget aid.

The ARTF has demonstrated considerable flexibility as a coordinated financing instrument, further increasing both its attractiveness to donors and its impact. The ARTF Incentive Program,[12] instituted at the end of 2008 and further developed subsequently, combined (1) a gradually declining baseline of ARTF reimbursements for the recurrent budget – signalling that as Afghanistan's domestic revenue increased, underlying dependence on the ARTF would fall over time; (2) linking higher ARTF recurrent budget reimbursements to a combination of revenue performance and stipulated progress on agreed policy reforms; and, more recently, (3) an operations and maintenance (O&M) facility to incentivise increases in O&M spending and improvements in fiscal flows to provinces. The incentive program represents a good-practice innovation that builds on the earlier success of the ARTF.

Why LOTFA Didn't Work so Well, in Contrast to the ARTF

The Law and Order Trust Fund of Afghanistan (LOTFA), administered by UNDP and mainly used to pay police salaries, has not performed very well – in contrast to the ARTF. While security expenditures raise particular challenges, the problems of LOTFA appear to go well beyond such issues. Although the fund has grown over time, as the size of the Afghan National Police increased and their wages rose, LOTFA has long been plagued by weak management and lack of oversight.[13] Not only have there been longstanding concerns about weak control over payroll and establishment and lack of verification, but outright corruption[14] (including procurement fraud[15] occurring over a number of years) involving LOTFA and UNDP staff came to light in 2012, which damaged LOTFA's credibility. Afghan President Ashraf Ghani's recent request that management of police salaries be transferred from LOTFA to the Afghan government, though not implemented as of the time of writing, reflects a broader perception that LOTFA has not worked well.

Unlike the nexus between on-budget aid, the ARTF, and public financial management improvements, the incentives of key actors involved in LOTFA do not appear to have been aligned in favour of strong fiduciary standards and financial controls. The Ministry of Interior (MoI), responsible for the police, has remained largely unreformed. Moreover, the *de facto* segregation of police funding through LOTFA from the civilian budget (which was partly funded through the ARTF) weakened pressures on MoI to improve, and may well have weakened the linkage between public financial management performance and payments from LOTFA.

For UNDP, public financial management was not a core area of expertise; nor did UNDP bring in outside public financial management expertise for LOTFA in the early years. Even though police salaries accounted for the overwhelming bulk of LOTFA expenditures (and associated management fees paid to UNDP), getting the nuts and bolts right – ensuring that funding for police salaries was appropriately utilised and properly documented with a reasonable degree of oversight – did not appear to be a top priority early on. And LOTFA donors appeared to have less appetite in the early years to hold UNDP or MoI accountable for public financial management performance than in the case of the ARTF, perhaps because international partners were more concerned about the quantitative expansion of the security forces and only secondarily about public financial management performance in the security sector. In recent years, bilateral donors (and their audit bodies, such as the US Department of Defense Inspector-General and SIGAR) have been much more vocal about the need for financial controls and the prevention of corruption in the security

[12] Details about the 'Policy Reform Program' can be found on the Afghanistan Reconstruction Trust Fund website at http://www.artf.af/policy-reform-program.

[13] The problems of LOTFA and UNDP's management are documented in UNDP evaluations (see http://www.ft.dk/samling/20121/almdel/uru/bilag/215/1271986.pdf) and audit reports (http://www.foxnews.com/world/interactive/2015/01/12/undp-desk-review/), SIGAR reports (http://www.sigar.mil/pdf/audits/SIGAR-15-26-AR.pdf), press accounts, and other public documents. See William A. and Scott Smith, "Ghani, UNDP, and The New York Times: Who Really Overreached on Paying Afghan Police," Foreign Policy *South Asia Channel*, 2 February 2015, http://foreignpolicy.com/2015/02/02/ghani-undp-and-the-new-york-times-who-really-overreached-on-paying-the-afghan-police/ and a number of sources cited therein.

[14] Nathan Hodge, "U.N. Fund Scrutinized for Afghan Corruption," *Wall Street Journal*, 10 May 2012, http://www.wsj.com/articles/SB10001424052702304543904577396421507307902.

[15] Meena Haseeb, "UN Trust Fund Agency Allowed Procurement Fraud in Afghanistan," Khama Press, 28 February 2013, http://www.khaama.com/un-trust-fund-agency-allowed-procurement-fraud-in-afghanistan-2232?keepThis=true&TB_iframe=true&height=600&width=900&caption=UN+trust+fund+agency+allowed+procurement+fraud+in+Afghanistan.

sector. A salient lesson is that such concerns need to be prioritised from the beginning.

4. CONTRIBUTING FACTORS TO PROGRESS OR LACK THEREOF

Five main contributing factors to progress – or lack of progress – in the field of macroeconomic and public financial management are discussed below:

Afghan Leadership and Management

A consistent theme since 2002 is that development progress has been greater where the responsible Afghan government institutions have had strong leadership and management teams, and limited where these have not been in place, irrespective of the *ex ante* level and quality of international support.[16] The starting point was usually a qualified minister who had a vision; he/she then assembled a technically qualified, effective Afghan management team that operationalised and implemented well-designed programmes that worked in the Afghanistan context. Foreign advisors were often involved in programme design, but under the leadership of Afghan management teams in the ministries concerned. Donors did not drive the process, but as programme implementation got going and achieved initial results, they flocked to success and provided increasing funding. The macroeconomic and public financial management spheres have been no exception to this general pattern; both MoF and, perhaps to a slightly lesser extent, DAB have had relatively strong senior management teams.

Resources for and Vulnerabilities to Corruption

A clear contributing factor to success was for institutions or departments *not* to be overly lucrative or attractive in terms of resources for corruption, especially if there were protections in place making exercise of corruption more difficult. In some cases (e.g., monetary and exchange rate management, budget process) resources for looting were pretty limited in the first place, whereas in others (public financial management) early actions reduced the vulnerability to corruption while the amounts of money were still relatively small. At the opposite extreme, Kabul Bank represented an enormous opportunity for theft and fraud with inadequate oversight, and customs revenues were a major target for corruption. The huge amounts of international military spending and off-budget aid during the 'surge' period, representing a highly lucrative target for corruption, probably contributed, at least to some extent, to the shielding of on-budget expenditures. But now, as international military spending and off-budget aid decline, the relative attractiveness and vulnerability to corruption of budgetary revenues and expenditures may well increase.

Below the Political Radar Screen versus Politically Exposed

Progress has tended to be easier for activities that were overtly 'technical' in nature and did not attract much political attention, such as the more technical aspects of macroeconomic management and nuts-and-bolts public financial management. Sometimes political imperatives aligned reasonably well with technical achievements – for example in the case of the currency reform and maintenance of a stable exchange rate for the Afghani, where considerations of national sovereignty came into play. On the other hand, where the political profile was higher, especially if intertwined with high-level political interests reaping financial benefits (e.g., Kabul Bank), not only was progress slower, but there was a risk of adverse, even disastrous outcomes.

Exploiting (or Missing) Windows of Opportunity

The window of opportunity for reforms was relatively open for several years following the downfall of the Taleban regime. This is not surprising; similar phenomena are observed in other countries – even in a much more normal situation, a 'political honeymoon' often follows a new government coming into office. So much more so in Afghanistan where the 2001 intervention was widely seen as a major turning point providing a great opportunity for change, a 'golden moment' for a country thought to be entering a post-conflict phase. The situation was fluid, the Taleban defeated and thoroughly discredited, and the elite power-holders who came back after being pushed out by the Taleban in the 1990s were not yet fully entrenched and probably uncertain about their prospects. Moreover, their political preoccupations were mainly with the key security agencies – the

[16] See William Byrd, "Responding to Afghanistan's Development Challenge: An Assessment of Experience During 2002–2007 and Issues and Priorities for the Future," World Bank *South Asia Region PREM Working Paper Series*, SASPR-11 (October 2007), p 22, http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2007/12/26/000020953_20071226093955/Rendered/PDF/416760REPLACEM1t0Challenge01PUBLIC1.pdf.

Defence and Interior Ministries and the National Directorate of Security – whereas MoF and DAB were not yet on the political radar (though MoF assumed increasing importance over time).

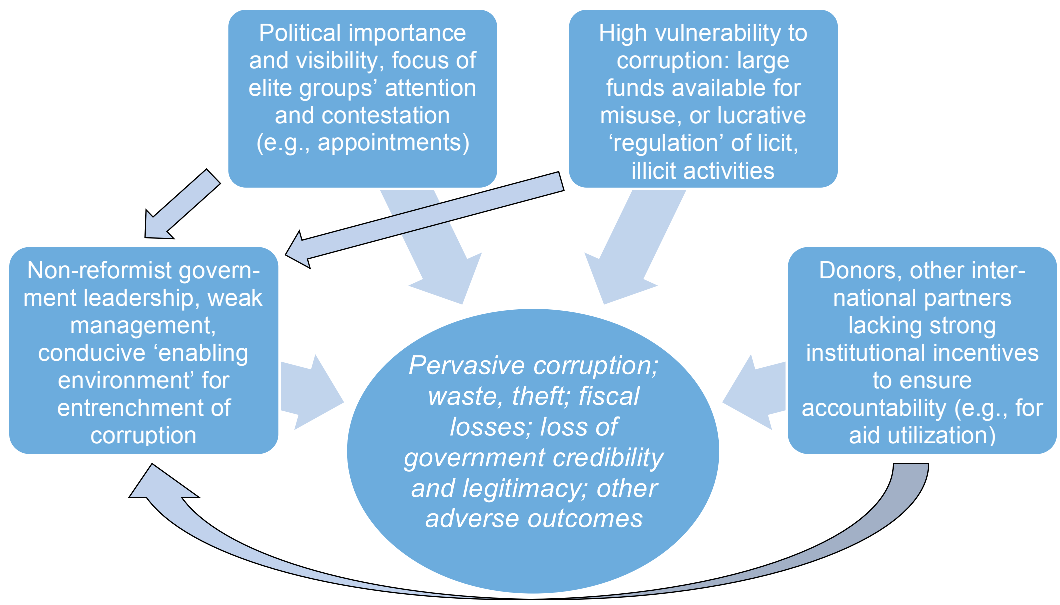
Reforms and good practices that were implemented fairly soon after the 2001 regime change had much greater prospects of being successful and sustained (if the enabling conditions were in place) than those attempted later in the face of more-entrenched political headwinds.[17] This pattern is evident in the case of national development programmes: those that were developed and implemented early on had greater prospects for success – for example, the basic package of health services and the National Solidarity Programme – than programmes started later. In addition to effective Afghan leadership of the Ministry of Communications, the early start with telecommunications reform contributed to the success achieved in this sector. On the other hand, progress was much slower in civil aviation where early reform efforts stalled and leadership was weaker, even though it is a sector where international experience demonstrates that rapid private-sector-based development is possible.

Incentives and Dynamics

The greatest success resulted from interventions that set in motion incentives and dynamics that promoted sustained progress over time. A good example is the nexus of incentives, instruments, and actions around on-budget international aid, primarily through the ARTF, and improvements in public financial management (see Figure 2). Broad consistency of narrow institutional objectives across the main actors involved, and incentives in the right direction, achieved sustained progress. Also critical is the need for vision and informed risk-taking to start a virtuous cycle; for example, a pro-active donor made a sizable contribution to the ARTF up-front, without waiting for everything to be in place or for demonstrated results. The relatively simple design of the ARTF, its flexibility to expand and evolve over time, and the priority it received from the World Bank as ARTF administrator – all were conducive to sustained progress. As a result, the ARTF mobilised a cumulative total of 8 billion US Dollars of on-budget aid during 2002–14.[18]

In other areas, however, incentives and dynamics

Figure 3
Adverse Incentives and Dynamics



Source: Author.

[17] See Byrd, "Responding to Afghanistan's Development Challenge" pp. 31–3 [see FN 16] for a more detailed discussion.

[18] Afghanistan Reconstruction Trust Fund, "Administrator's Report on Financial Status," 21 May 2015, http://www.artf.af/images/uploads/ARTF_Financial_Status_Memo_May_21_2015_Final_Draft_(2).pdf.

were not conducive to sustained success, or were even inimical to progress. Figure 3 depicts how varying combinations of political exposure and visibility, high vulnerability to corruption, and objectives and incentives of different key actors that were not mutually aligned and conducive to progress, could result in adverse outcomes. Prominent examples include the customs department within MoF (sizable resources to plunder and high vulnerability to corruption), private bank supervision within DAB (high-level political connections of Kabul Bank, scope for massive theft and fraud), and LOTFA (unreformed Ministry of Interior, weak incentives for public financial management improvements for the main entities involved).

5. LESSONS, LIMITS, OBSTACLES, AND PROSPECTS

Lessons from Afghanistan's Experience in Macroeconomic and Public Financial Management

Important lessons can be learned from Afghanistan's experience with macroeconomic and public financial management since 2001 – both for key Afghan government institutions and the political leadership, as well as for bilateral and multilateral international partners. Some of these lessons may be applicable to other spheres of activity, as well as to other post-conflict countries.

Take Advantage of Windows of Opportunity

The first few years after 2001 saw a disproportionate share of successful initiatives that achieved major progress. Virtually all the achievements in the economic management and public financial management spheres were set in motion then, reflecting the fluidity of the situation and relatively less-entrenched political interests, which left space to put in place sensible economic policies and reforms. Once a window of opportunity has closed, it becomes much more difficult to build and sustain momentum for progress.

Build on What Already Exists

The currency reform is a good example of facilitating progress by relying on existing capacity and/or practices. Another example is the use of the existing Afghan budget accounting system as a basis for initial public financial management improvements, rather than starting with a completely new accounting system.

Simple, Flexible Instruments and Interventions

Macroeconomic instruments were rudimentary, including most prominently the regular auctions of US Dollars by DAB to stabilise the exchange rate, manage the money supply, and limit inflation. The ARTF started out with a simple design but had the flexibility to evolve and build on success over time.

Incentives and Dynamics Are Crucial

Rather than pursuing one-off interventions or repeatedly trying to make inroads against a static target, the key for both government and donors is to set in motion positive incentives and dynamics that cumulatively build progress over time and, at least to some extent, become self-sustaining (e.g., public financial management).

Learning by Doing Is Key for Sustainable Success

Public financial management improvements came about through successive years of implementation, starting from a small and rudimentary base. Implementing computerised payments and accounts, enhancing the quality of the Afghan national budget, and developing a more programmatic approach in key sectors are all examples of such learning by doing.

Sound Macroeconomic Management Makes a Positive Difference – and Is Feasible

Afghanistan's problems would have been greatly exacerbated if macroeconomic management had been poor, which could have resulted in adverse outcomes such as high inflation, exchange rate instability, and/or dissipation of foreign exchange reserves.

More Technocratic, Less Overtly Political, Activities Provide Fertile Ground for Reform

Key dimensions of public financial management benefited from being below the political radar screen and from being seen as 'technical' activities; the same applied to macroeconomic policies and instruments.

There are Limits to Technocratic Reforms – the Politics Matters

Even in more technical areas, political space for progress has been a critical success factor. This calls for greater political awareness on the part of donors and a political strategy by the government to provide the necessary political space – the latter cannot be left to chance, as was largely the case in the previous administration.

Corruption Once Entrenched Is a Serious Drag on Progress and Can, in Worst-Case Scenarios, Be Disastrous

Widespread corruption has become a dominant concern in Afghanistan. If financial accountability and integrity are not prioritised up-front, dealing with corruption later, when it has become entrenched, becomes far more difficult.

Looking Ahead: What All This Might Mean for Afghanistan's Future

While there have been important examples of success, Afghanistan's experience also shows the limits to progress in the macroeconomic management and public financial management spheres, as well as likely obstacles to further progress. These lessons from experience therefore need to inform future policies, even while taking into account that the situation is changing. In this regard, Afghanistan is likely to face five main types of challenges:

The Political Limits to Technocratic Reforms

Experience has amply demonstrated that considerable progress can be made in technocratic reforms, as long as there is political space. The political space, however, even for more technocratic reforms, appears to have narrowed during the latter part of the Karzai administration, as a result of the entrenchment of elite networks and pervasive patterns of patronage.[19] Former President Karzai's style of political management and his growing control within the government meant that keeping reform areas insulated from politicisation became increasingly difficult over time. While economic management and public financial management have tended to be less vulnerable to this narrowing of political space, they have not been entirely exempt.

During the nearly 13 years he was in office, President Karzai was not a reformer or a strong advocate of institutionalisation, but was mostly preoccupied with day-to-day political management. Progress thus depended on the leadership in the ministry or agency, whether they were inclined and had political space to take forward reforms and development policies, and the extent of entrenched corruption. The political configuration of the new administration may turn out to be different. There is now a reformist president, but also a more complex formal political arrangement that appears to be hindering reform and posing challenges for day-to-day political management. Whether the previous model – messy day-to-day politics but with space for reforms and development progress in a few well-led and effectively managed ministries and agencies – will be maintained is unclear.

Increasingly Entrenched and Pervasive Corruption

One factor that contributed to success in the past was the ability to avoid or curtail the widespread and more egregious forms of corruption in a certain sector, ministry, or area of activity – effectively creating relative 'islands of integrity.' Corruption, however, appears to have become more pervasive and entrenched over time, reflecting *inter alia* the following:

- *Huge inflows of resources vulnerable to corruption*, in the form of international military expenditure in-country and off-budget aid, which peaked during the 'surge' period at tens of billions of dollars per year – well exceeding Afghanistan's GDP.
- *Rising government revenues*, which as they increased over time became lucrative targets for corruption – this applied in particular to customs duties but also to other tax and non-tax revenues.
- *Enhanced government functionality and regulatory and service delivery roles*, which provided scope for extortion of bribes and favours; government procurement and mining contracts are prominent examples of high vulnerability to corruption.
- *Entrenchment of patronage networks and lack of high-level political checks against corruption.*

In the face of entrenched and pervasive corruption, it may be increasingly difficult to maintain 'islands of integrity' such as core public financial management functions.

From Too Much Money to Perhaps Too Little – How Well Will Exclusively Negative Public Financial Management Incentives Work?

[19] See William Byrd, "Afghanistan: Nurturing Political Space for Development," Chatham House *Opportunity in Crisis* Series No. 3, May 2015, http://www.chathamhouse.org/sites/files/chathamhouse/home/chatham/public_html/sites/default/files/20140501AfghanistanNurturingPoliticalSpaceByrd.pdf.

Increasing aid during the first half of the post-2001 period (starting from an extremely low level in 2001), albeit much more modest than later, generated important positive incentives for the Afghan government and other actors, supporting beneficial dynamics as discussed earlier (see Figure 2). While negative incentives were tied to financial requirements for ARTF reimbursements and ARTF contributions, these functioned within an overall environment of increasing on-budget resources, where good performance of development programmes and improvements in public financial management led to more aid funding. A key question is whether, in the current fiscal squeeze, with the need to protect security sector and other basic expenditures (e.g., civil servants' salaries), having only negative incentives can continue to stimulate public financial management improvements. A related question is whether negative incentives in the current environment can be very credible, when they might result in, at the extreme, non-payment of salaries for example.

Challenges of Macroeconomic Management with Severe Resource Constraints, Slow Economic Growth

Good macroeconomic management in Afghanistan since 2001 was facilitated by large inflows of resources – aid, fiscal support, and foreign exchange. Rapid economic growth fuelled by these inflows meant that difficult trade-offs in macroeconomic and fiscal management could be avoided. In particular, the negative impact of tight fiscal policy on aggregate demand was not relevant since the economy was, if anything, overstimulated by financial inflows, and there was no need for deficit financing to further increase demand. This does not detract from Afghanistan's achievements in macroeconomic management, not least because in any country, avoiding major mistakes on the macro front is important and should never be taken for granted. However, in the current low-growth environment and facing a fiscal crisis, macroeconomic management by MoF and DAB will be much more difficult.[20]

The 2014 Political Transition – Loss of a Window of Opportunity?

Ahead of the presidential election, concerns were voiced that it might go badly wrong or even break down, with a risk of election-related conflict. It was widely felt, however, that if the election went well, the change to a new administration would provide a window of opportunity to renew reforms, take forward a meaningful anti-corruption agenda, and make a good start in the post-transition decade.[21] The election fortunately did not break down into outright violence, but the drawn-out process of finalising the outcome, the negotiations over the national unity government, and its slow start may well have vitiated the expected window of opportunity. Cabinet formation was long delayed, and, as of the time of writing, a prioritised reform action programme had not yet been promulgated. Now, more than a year after voting in the 2014 presidential election was completed, the window of opportunity that normally ensues immediately after a change of government may have to a large extent closed.

Concluding Thoughts

This paper has shown that in the macroeconomic management and public financial management spheres, considerable successes have been achieved since 2001, although examples of slow progress or major failure also exist. Afghanistan's experience provides important lessons both for the country itself – as it faces a difficult economic situation in addition to other major challenges – and for other countries affected by conflict and fragility.

[20] Challenges include exchange rate depreciation, much more effective fiscal expenditure prioritisation, robust revenue mobilisation but minimising any recessionary consequences for the private sector, and how to jump-start economic growth.

[21] As suggested in Byrd, "Afghanistan: Nurturing Political Space for Development" p 3 [see FN 19]: "…there may be a window of opportunity in the months immediately after the new government takes office to institute improvements and restore and expand the space for development-oriented policies and investments."

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ABOUT THE PAPER

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