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Longing for a Boom: Prospects for Economic Development in Afghanistan

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The unrelenting military operations carried out in Afghanistan since the end of the 1970s brought about unprecedented devastation of the existing infrastructure and determined the abject economic condition of this state. Currently, the economic situation is improving, although Afghanistan is still facing a series of structural and other barriers (pervasive corruption, weak economic governance, and a shadow opium economy) to its growth, while reconstruction is still slowed down by continuing military conflict in the country. In the short-term perspective, Afghanistan will not be able to develop without serious economic assistance from donors. However, it may improve its economic standing in the long-term by supporting the development of traditional agricultural economy and creating conditions for local and foreign investors, which may provide capital and necessary know-how for exploring its vast mineral potential.

After 2001, the international community engaged in unprecedented economic assistance for the Afghan state. Many projects aimed at stimulating the Afghan economy were implemented in order to boost economic growth and create conditions for sustainable development. And although one may agree that many of them succeeded (such as the 2,000 km "Ring Road" connecting provincial capitals in Afghanistan), the permanent lack of internal stability and numerous other factors will undermine these modest achievements. Despite creating many institutions that are intended to build Afghan capabilities in this area, such as the Afghanistan Investment Support Agency, the Ministry of Mines and Petroleum, the Export Promotion Agency of Afghanistan and the like, the country's economic future is anything but predictable.

Historical Background

In the pre-war period, Afghanistan's economy was based mainly on agriculture (approx. 50% of GDP and as much as 80% of the work force) and animal husbandry. Their efficiency was limited by topographic considerations (the majority of Afghan territory is mountainous) and climate limitations (droughts, insufficient rainfall, and hard winters). Until the end of the 1970s, however, Afghanistan was self-sufficient in terms of foodstuff production, and even managed to export some surplus (mainly dried fruit and nuts), as well as minerals (chiefly gemstones) and pelts.

The country has never developed a strong industry—only in the north were there a few textile and shoe factories (cotton was produced, and caracul furs and rugs were manufactured and exported to the USSR, the United Kingdom, and Afghanistan's neighbours), chemical plants (household detergents and fertilisers) and construction companies. All in all, industry employed as little as 10% of the work force (construction 6%, trade 5%, and services 11%). The development of trade and export was also hampered by natural barriers, such as Afghanistan's status as a landlocked country and the necessity to rely on transit routes through neighbouring countries.

As far as budget revenue is concerned, taxation never constituted a significant source of state income. There was, admittedly, an agricultural tax, but direct taxes never accounted for more than 10% of revenue. The largest part of the budget, approx. 47%, was due to indirect taxes from companies and state monopolies. At the end of the 1970s, revenue from natural gas and oil extraction grew in importance.

More than half of the budget came from external sponsors, and this capital was invested in security structures, infrastructure (mainly transport), education, and agriculture.[1] Protracted wars radically reduced the Afghan state's already meagre capabilities to meet the basic needs of society. In particular, the Soviet invasion was a time of total devastation of numerous utilities—including agricultural and transport infrastructure, and involved the destruction of field irrigation systems as well as poisoning of wells and water intakes—coupled with widespread laying of land mines on farm land. Afghanistan's farming potential is estimated to have shrunk by one third between 1979 and 1987. This period also saw the disintegration of the state, followed by rampaging inflation and significant devaluation of the Afghan currency in the 1990s. The 1990s were, however, also a period of slight economic growth, with recovering agricultural production and animal husbandry, incoming international aid, and returning refugees.

The Economic Recovery Plan after 2001

Soon after the removal of the Taliban regime from power, as early as in April 2002, the National Development Framework was presented, and a few months later a $349 million budget was drafted for 2002–2003 (two-thirds of this amount was assumed to come from donations, and the funds were supposed to finance the creation of the institutional foundations of the Afghan state almost from scratch). Budget revenues ran at that time at approx. $132 million. The subsequent meeting of donors in Tokyo (2002) saw the participating countries declare $4.5 billion for the following five years. Until 2013 this amount was supposed to rise to almost $90 billion. As it happened, until 2011, only $57 billion was distributed.[2] The international community remitted 96% of Afghan foreign debt, amounting to approx. $12 billion, within the framework of the Heavily Indebted Poor Country Initiative.

Despite these efforts Afghanistan is still struggling economically. Although estimates on GDP per capita indicate that the situation is improving by the year, and the figure grew from $307 in 2007 to $576 in 2011, millions of Afghans live below the threshold of poverty (36% in 2008, still an improvement on the 2003 figure, which rose sharply to 53% from the 23% posted in 2002).[3] In 2013, Afghan GDP, according to World Bank data, stood at approx. $27 billion, and budget revenues are largely determined by weather conditions affecting the volume of the cereal harvest.[4]

The budget capacity of the Afghan government is therefore largely dependent on international aid. A large part of this is transferred via the Afghanistan Reconstruction Trust Fund (ARTF) managed by the World Bank. It is fed by contributions coming from 33 countries, which, starting from 2002 earmarked more than $5 billion in aid for budget expenditure (such as salaries for state employees, which consumed approx. 50% of ARTF funds, and investments). Priority sectors included agriculture, rural and urban development, the judiciary, stimulating the private sector, education, transport and power generation. The authors of the U.S. Government Accountability Office Report emphasise that, between 2006 and 2010, approx. 90% of security-related expenditure, such as financing the Afghan security forces, was provided by the United States, and only 6% by the Afghan government and 4% by other donors.

Despite the worsening security situation, particularly in southern provinces, recent years saw economic growth. In 2012 it stood at 11.8%, up from approx. 8.4 % in 2010–2011, but less than the 22.5% recorded in 2009. In 2013, however, it reached only 3.1%, which many experts attribute to growing investor uncertainty regarding security issues following the withdrawal of the ISAF.

[1] Aid was provided by the American USAID agency, which funded irrigation systems in southern Afghan provinces.
[2] See *Aid and Conflict in Afghanistan*, ICG Asia Report No. 210, 4 August 2011.
[3] Data from Index Mundi, www.indexmundi.com/g/g.aspx?c=af&v=69.
[4] See: R. Hogg, C. Nassif, C. Osorio, W. Byrd, A. Beath, *Afghanistan in Transition: Looking beyond 2014*, The World Bank, 2013, pp. 1–21.

The country is also a beneficiary of FDI. This stood at approx. $270 million in 2001 to 2005, but was very volatile after 2006 (around $60 million in 2013, down from $90 million in 2011 to 2012). The largest contributors include Turkey, the United Arab Emirates, the U.S. and Canada. Afghanistan's neighbours, in turn, in particular state-owned companies from India and China, are interested in the extraction industry. Experts claim, however, that many of the investments made were motivated by the military and civilian presence of these countries in Afghanistan (with infrastructure projects as one of the examples cited) and the continuation of this trend after 2014 cannot be taken for granted. The largest investment projects include high quality farming, improvement of infrastructure, the mining industry, construction, the creation of transit routes, and more. The largest donors and organisations supporting Afghan reconstruction include the World Bank, the International Monetary Fund, the European Commission, the Asian Development Bank,[5] the USAID agency and state individual donors transferring their aid both through the above-mentioned institutions as well as bilateral channels. Recent years have also seen the rise of new proposals to use Afghanistan as a transit country for natural gas from the Caspian Sea southward, for example by constructing TAPI pipelines running through Turkmenistan, Afghanistan and Pakistan to India.

The Problem of Opium Cultivation and the Shadow Economy

One of the most important barriers to restoring a traditional agricultural economy and food production are the benefits coming from opium cultivation and the lack of alternative livelihood possibilities. In the face of the state's dramatic situation and the lack of infrastructure, the cultivation of poppy seed has become an ever more popular source of income for farmers.[6] In recent years Afghanistan became the largest global producer and exporter of opioids (approx. 90% of total production). Revenue from the sales has been estimated at as much as 50% of legal GDP, though sources differ largely in this respect, some claiming no more than 4% (the United Nations Office on Drugs and Crime data). The practice started on a larger scale after the Soviet invasion, benefitting both the government and the mujahideen by generating revenue, the lion's share of which was assigned to the financing of military activities and to building political influence in the provinces by allowing the reconstruction of the destroyed infrastructure (hospitals, mosques).

All efforts to eradicate the crop failed, and poppy fields spread to previously spared areas (for example, the northern province of Badakshan). There are at least several reasons why it is very difficult to redirect Afghan agriculture to legal crop cultivation, such as nuts, fruit or vegetables. A big role is played by objective factors such as poor soil and difficult climate conditions (harsh winters and prolonged droughts, the disastrous effects of which cannot be held off by irrigation systems that are antiquated or that have been destroyed during the protracted wars). These circumstances do not favour the cultivation of more demanding crops, taking into account that the risk of failure or crop destruction is high. Moreover, the poor distribution network is a serious obstacle for the success of legal farming. While distribution channels work very well for opium (dealers reach the farmer directly and undertake the risk of transport and delivery), in the case of less profitable crops the possibility of reaching the customer drops dramatically (in particular due to non-existent road infrastructure, as many towns and villages have no road connection with provincial capitals, and there are no storage facilities that would prevent food from rotting during transport[7]). There is a dire lack of storehouses and cold stores. The World Bank reports claim that as much as 60% of foodstuffs go bad before reaching the market. Despite the adoption of a few strategies for facilitating farmers' access to trade centres in cities (such as the National Rural Access Programme), progress in this respect is very slow, and the lack of national programmes for micro financing cereal or fruit production is sorely felt. The situation is not improved by slim possibilities of controlling cross-border opium distribution channels, since long stretches of the state borders (in particular the border with Pakistan) are devoid of any check points, creating ideal smuggling conditions.

Finally, giving up opium cultivation is difficult to control, taking into account such factors as its enormous profitability coupled with relatively undemanding requirements with respect to soil quality or climate in

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[5] For instance, in 2010 the Asian Development Bank established a trust fund for the financing of infrastructure reconstruction in Afghanistan. The most significant contribution came from the Japanese government and amounted to $20 million. Data from *Aid and Conflict in Afghanistan…*, *op. cit.*, p. 10

[6] In fact, opium cultivation in Afghanistan began in the mid-1950s, and in 1970s Afghanistan became an important provider to the Western markets. More about the historic development of this phenomenon in: V. Felbab-Brown, *Shooting Up: Counterinsurgency and the War on Drugs*, The Brookings Institution, 2010, pp. 114ff.

[7] R. Hogg, C. Nassif, C. Osorio, W. Byrd, A. Beath, *op. cit.*, pp. 1–21.

comparison with other crops, as well as the ease of storage. Estimates show that a farmer taking up poppy seed cultivation can count on a twentyfold increase in revenue, resulting in a huge leap up the social prestige ladder (based on such new possibilities as securing dowries for daughters, meeting extremely elevated fees for sons' weddings paid to the family of the bride, providing medical aid for the family, purchasing a car, and so on).[8] Moreover, apart from the real income for producers, in Afghan realities opium cultivation is a matter of sheer survival for whole farming communities, given that the current level of unemployment reaches 35%, and according to the reports of the United Nations Office of Drugs and Crime and the Afghan Ministry of Counter-Narcotics, families that opt for taking up such cultivation are significantly better off than those that plant cereals. According to estimates, at least three million Afghans cultivate opium (discounting members of their families, seasonal workers, and others).[9] One of the most important barriers to overcoming the problem is the attitude of the Afghan government itself, in which prominent posts are held by former warlords linked with the drug business, who want to keep the income from this trade. The largest beneficiary of opium cultivation is organised crime, most often closely linked with the armed rebellion and warlord militias. Thanks to the revenue from the illegal drug trade, warlords are able to finance their armed units and maintain de facto control over large swathes of the Afghan territory.

Natural Resources

Afghanistan's dramatic economic situation stands in stark contrast to its gigantic pool of natural resources, which, if used properly, would change the economic condition of this state decisively, generating huge revenues for the budget from export, extraction fees, licenses, and so on. (the extraction industry is currently estimated to be worth $1 trillion, and that only takes into account the area so far explored). Awareness of the Afghan potential in this respect dates back to as early as the beginning of the 19th century. Traditionally, Afghanistan is associated with gemstone mining (lapis lazuli mines in the Badakshan province, and emeralds and rubies in Jegdalek, east of Kabul[10]), but according to data presented by the U.S. Geological Survey and the Afghan Ministry of Mines and Industry, the Afghan territory harbours rich hydrocarbon deposits as well as minerals and other natural resources.

Reports indicate the presence of enormous amounts of gold, copper, coal, iron ore, as well as 1,400 other minerals (such as zinc, chromium, uranium, cobalt, and the rare earth metals) as well as non-mineral deposits such as celestite, talc, marble, calcium, and others. There are also important hydrocarbon deposits, though extraction possibilities remain unclear. According to World Bank estimates, hard bituminous coal, for example, has a huge extraction appeal with production potentially capable of rising from the current 140,000 tonnes to as much as 800,000, bringing a fourfold increase in revenues (from $10 million to $40 million). As for oil and gas, these deposits are estimated at almost 16 trillion cubic feet and 1.6 billion barrels, respectively, which, according to experts, would make Afghanistan independent of external providers.

In recent years the Afghan government has already begun serious preparation for the extraction of certain raw materials. In 2008, the China Metallurgical Group was granted a concession to extract six million tonnes of copper from deposits in Anyak in the Logar province, and estimated budget revenue on this will reach $1.2 billion annually in the coming 30 years. Additionally, it is estimated that, when extraction begins, 5,000 jobs will be created around this business. India is another important investor, concentrating on iron ore extraction in the Hajigak mine, on the basis of a concession grant obtained in 2011. Afghanistan's lithium potential also offer high hopes, as some experts evaluate that the existing deposits justify calling the country the "Saudi Arabia" of lithium.

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[8] Individual rationale of farmers taking up opium cultivation has been described in studies by David Mansfield, one of the most respected British experts in the field. See, for example, D. Mansfield, *Responding to Risk and Uncertainty: Understanding the Nature of Change in the Rural Livelihoods of Opium Poppy Growing Households in the 2007/08 Growing Season*, July 2008, www.davidmansfield.org/field_work.php.

[9] In Afghanistan itself, demand for opioids is growing regularly. According to UNDOC data, almost a million people take drugs regularly, with 700,000 of them deprived of any access to drying-out treatment. Drugs are given to children by 50% of parents. Data from *Afghan Drug Survey 2009*, UNODC, www.undoc.org.

[10] There are also many other types of gemstones extracted in Afghanistan, including aquamarine, garnet crystals, and more, in Badakshan and Nuristan. See, for example, U. Markus, *Minerals key to Afghan development,* International Security Network, August 2007, www.isn.ethz.ch/isn/Security-Watch/Articles/Detail/?lng=en&id=53618.

Prospects for Development

Despite amazing natural resources, Afghanistan has never been able to rely on its own efforts and has continued to depend on external help. According to Barnett Rubin, a prominent expert on Afghanistan, in 1958–1968 and since the mid-1970s, around 40% of state expenditure was covered from foreign aid (with security expenses reliant almost entirely on external funding). This was possible due to its status of a buffer country, which transformed Afghanistan into a "rentier country" and absolved the authorities from any responsibility, but in turn made them dependent on external donors. Therefore, experts see the USSR and the UK as the main agents thwarting Afghanistan's development, precisely for the above mentioned reason of creating Afghan governments' dependence on foreign aid.

The same was the case in post-2001, when 40% of the Afghan national budget (est. $7 billion annually) was funded by international sponsors (with 100 % of development investment supported by foreign funds), making Afghanistan an aid-addicted country. Moreover, the specific security situation resulted in introducing investments connected mostly to the presence of international troops, which meant supporting the service economy (communication, transportation, finance and banking and the like) and not agriculture and food processing branches, which are beneficial for the whole Afghan society. As the Afghanistan Statistical Yearbook shows, the service sector generates more than 50% of the GDP.

Although many indicators point to a gradual improvement of the economic and social situation in Afghanistan, the country will have to rely on international aid in the short-term. In the longer-term, there is, however, a chance to reverse this negative trend. To accomplish this goal, the Afghan government must undertake several steps to unlock the country's economic potential.

Firstly, a sustainable, long-term economic strategy must be introduced, replacing dozens of sub-strategies provided mostly by international consultants and concentrated mainly on macro-economic indicators. This will require some serious steps from the Afghan government, aimed at improving its economic governance, investing in local human resources capabilities, introducing the rule of law, and assuring broader public participation in creating economic strategy. Over several recent years, Afghanistan has established numerous economic agencies that are trying to implement different strategies, without coordination. As a large part of the Afghan budget coming from international donors was distributed outside government control, there is a lack of developed capacity on every level, including planning revenues and expenditures, budget execution, predicting trends in economic development in a difficult security situation, collection of reliable data and the like.

Secondly, the Afghan government pins its hopes on natural resources, but it must be kept in mind that extraction is an immensely energy and capital-intensive industry, and before resources are mined even on a small scale, the country must make infrastructure investments (power plants, access roads, providing supplies of water by signing agreements with neighbouring countries and the like). The volatile security situation in Afghanistan continues to make the investment risk high (some experts claim that discovering the resources' potential may even threaten the stability of the state; if, following the withdrawal of the ISAF, the government in Kabul is weakened and the factions concentrated around former warlords come to the fore, they may try to regain their former prominence by taking control of areas rich in resources and draw profits from their extraction). Moreover, the Afghan government has to consider carefully how to assure that potential jobs in the extraction industry will be taken by the Afghans, as there is a risk that potential investors (China in particular) will engage their own workforces.

Thirdly, the dynamic development of the Afghan economy is also hampered seriously by ever-present corruption, which increases the cost of doing business dramatically. According to Transparency International's Corruption Perceptions Index for 2014, Afghanistan came out 172nd (out of 175 countries) in the global corruption ranking. This situation is self-perpetuating, despite regular pressure exercised by the international community on the Afghan government. In 2009, U.S. president Barack Obama wrote to Hamid Karzai, demanding that the Afghan authorities devote more attention to tackling corruption, and to bringing to account individuals responsible for the biggest corruption scandals in the country. The requests did not meet with a favourable reception. The recent collapse of the Kabul Bank only fuelled concerns of foreign investors. Some steps have already been taken in the mining industry, with the implementation of the Extractive Industries Transparency Initiative that is supposed to assure transparency of contracts in this area.

Fourthly, the Afghan government has to improve its reputation as an investor-friendly country. According to the World Bank report *Doing Business 2015: Doing business in a more transparent world*, Afghanistan ranked 183th among 189 countries in terms of facilitating business. The report points to such factors as unsolved land ownership issues (often obtained via private connections) or difficulties in accessing capital. Corruption in turn is mentioned as one of the most important obstacles to doing business in another World Bank report (*The Investment Climate in Afghanistan: Exploiting Opportunities in an Uncertain Environment*, 2005) which emphasises that the phenomenon has become ever more acute, and is affecting mainly private companies and Afghan repatriates. The report also provides data which show that approx. 8% of the value of any sales contract must be earmarked for sweeteners. In the future, this will discourage foreign investors as well as donor countries. Many experts claim that the institutional weakness of the state, which is unable to impose its authority in certain provinces (including regions rich in natural resources), must be factored in by investors and would lead them to favour caution rather than prompt investment of their capital in Afghanistan.

Fifthly, many experts claim that the Afghan government must concentrate in the nearest future on assuring the development of private small and medium enterprises (SMEs) in the areas of agriculture and food production, or handicrafts, construction, transportation, light industry and so on, as these create the biggest potential for sustainable development and will create necessary trade networks in the region (with Pakistan, Iran, and India). Apart from investing in large-scale infrastructure projects, the administrative barriers for setting such businesses should be removed and a generous pool of small grants must be assured, to provide a necessary incentive for start-ups. These resources may come from neighbouring countries such as India or Iran, which are already serious investors in Afghanistan (India has already promised to invest $100 million to upgrade Chabahar port in Iran, in order to improve trade with Afghanistan and other Central Asian countries). As the SMEs cannot operate without the necessary infrastructure, there is also a need for public-private partnerships in planning bigger investments (those requiring serious energy or water consumption, for example).

In the light of the above, Afghanistan appears to be far from becoming the centre of a New Silk Road, as some politicians and experts would wish. They picture this country as a transit hub, acting as a venue for trade, the transfer of energy commodities, and so on. However, the complicated political situation and security concerns will continue to hold back this bold vision for a long time to come. In the coming years, the main problem that the Afghan authorities will face will consist of a possible outflow of investment after the withdrawal of international forces, potentially drawing down the growth momentum observed in recent years and throwing Afghanistan into recession. If, however, the Afghan government manages to overcome some major obstacles to its development, its regionally integrated market could provide substantial revenues to the budget coming from food and agricultural production for internal and external markets, oil and gas pipeline revenues, taxation, transit fees, transfers of technology for exploration of its vast mineral potential and the like. Both Afghan society and the international community place a lot of hope in the new president, Ashraf Ghani, a western-educated politician who served before as Afghan finance minister (2002–2004) and gained a reputation as being particularly skilled in undertaking necessary reforms and moving Afghanistan from a “war economy” to a “peace economy.”