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Chairman Tierney, Ranking Member Flake, Members of the Subcommittee:

Thank you for inviting me to appear before you today. I am pleased to have the opportunity to participate in this important hearing on U.S. assistance with respect to the Afghan economy.

The title of this hearing is “U.S. Promotion of the Afghan Economy: Impediments and Opportunities.” I’d like to begin by stepping back to ask why promoting the Afghan economy is of interest to this Subcommittee on National Security and Foreign Affairs.

The Complex Legitimacy Crisis in Afghanistan

I would suggest that the Afghan economy is principally of interest to us because its performance is one element of a much broader crisis of legitimacy with which the Afghan state has been struggling. This broader legitimacy crisis has been playing a central -- perhaps the decisive -- role in the in the resilience of the insurgency that has plagued Afghanistan and threatens U.S. interests. As the Army/Marine Corps Counterinsurgency Field Manual puts it, “Legitimacy is the main objective. ... A [counterinsurgency] effort cannot achieve lasting success without the host nation government achieving legitimacy.”

However, the economy is just one of a number of key elements of Afghan legitimacy. In my former legal practice as an adviser to sovereign governments in resolving debt crises, I observed a number of countries experiencing financial and economic crises where the economic crisis alone was the sole or primary factor that undermined legitimacy and (in some cases) brought down governments. That is clearly not the situation in Afghanistan. Instead, there are at least three other elements of government legitimacy that arguably play a more significant role in the current crisis. First, security: governments are expected to be able to protect their populations. Second, political: a critical mass of citizens must have a basis for politically identifying with their leaders, whether through elections or some form of traditional authority. Third: governance: the government must perform basic governmental functions and provide essential services (in accordance with local traditions and expectations).

Fortunately, the President's new strategy for Afghanistan has components that address each of these other elements, which are largely beyond the scope of this hearing (although I will return to governance below).

What the Centrality of Legitimacy Means for U.S. Assistance to Afghanistan

Nonetheless, I think it is useful to lead with this point about legitimacy for two reasons. To begin with, recognizing that the economy is only one element of a legitimacy crisis with multiple significant elements helps us to keep its significance in perspective. "Fixing" the economy (putting aside for the moment what that would mean in the context of Afghanistan) would not "fix" an Afghanistan in which the population is still living in conditions of extreme insecurity, in which the citizens regard the government as corrupt or having held on to power through unfair means and in which the government is seen as incapable of performing basic functions to even the most modest standards. While it is possible that economic development and improved economic prospects could contribute to making some of these other challenges a little easier to address (e.g., by decreasing the recruiting pool for economically-motivated insurgents), I have not been persuaded that the economy is the most important element of the legitimacy crisis in Afghanistan or the key to addressing all of the other elements just mentioned.

This is probably fortunate, because Afghanistan is, and is likely to remain, one of the poorest countries in the world – fifth from last according to the 2007 Human Development Report. While I will turn shortly to some things that we can do that could help improve the economic prospects of its citizens and increase its level of economic development, we should recognize that the changes possible are marginal improvements over time, leaving Afghanistan a very poor country for the foreseeable future. Consequently, I think there are uncertainties about any strategy premised on economic development producing dramatic changes in the situation, at least before the medium or long term. We should not overpromise about what even a substantial improvement in the Afghan economy would deliver in terms of the overall situation.

Shortcomings of Past U.S. and International Assistance to Afghanistan

The other reason I believe it is useful to frame the issue by reference to the Afghan legitimacy crisis is that it helps explain why it has been so difficult for the U.S. or other international actors to assist Afghanistan in ways that help solve the crisis rather than exacerbate it. On March 30 of this year at a conference on Afghanistan at The Hague, Secretary of State Hillary Rodham Clinton described the amount of money spent on Afghanistan over the past seven years without producing more visible results as "heartbreaking." "For those of you who have been on the ground in Afghanistan, you have seen with your own eyes that a lot of these aid programs don't work. There are so many problems with them. There are problems of design, there are problems of staffing, there are problems of implementation, there are problems of accountability. You just go down the line." Accordingly, the President's new strategy for

Afghanistan and Pakistan calls for both a significant increase of civilian resources and “a new model of how we allocate and use these resources.”

Why has past U.S. and international assistance to Afghanistan failed to produce more visible progress in economic development and a more secure country? I believe there are two fundamental explanations. The first is that our assistance has often been insufficiently related to Afghan priorities and institutions, substantially limiting both its effectiveness and its contribution to government legitimacy. Because international assistance is appropriated and planned back in capitals, and most often implemented by officials and contractors from the donor countries, getting detailed Afghan input about priority needs and the strengths and weaknesses of existing governance or civil society institutions is difficult, and setting up donor systems for implementing assistance that operate parallel to but distinct from existing Afghan systems is too often the default. Local capacity seen as weak (and alien) by Western donors and concerns about corruption further exacerbate this tendency.

The second fundamental explanation for the poor results from international assistance is that the international efforts themselves – originating in and driven by the varied national priorities and organizational dynamics of each donor nation and agency – naturally tend toward fragmentation. When development intervention A is the priority for donor X and development intervention B is the priority for donor Y, the normal outcome is for each to pursue its own priority. While particular donors can try to align their individual efforts with Afghan priorities and institutions, overall the multiplication of distinct donor efforts makes it more difficult for the Afghan government to keep track of and influence the assistance, so in practice this second problem (the fragmentation of donor efforts) tends to exacerbate the first (poor alignment with local priorities and institutions). Here, too, the consequence has been to limit both the effectiveness of assistance and its contribution to government legitimacy.

Afghan Business Impressions of U.S. Assistance

Confirming these general tendencies in U.S. assistance, below are some points made by Afghan businesspeople at a recent conference in Washington on “Making the Private Sector Work in Afghanistan”:

- *Afghan capacity (both private sector and governmental) is currently underutilized.* While corruption is a problem, it is hardly unique to Afghanistan and Afghan actors are capable of producing some results despite it. If Afghan companies are given more responsibility/empowered, their capacity will improve. For all the limitations of the Afghan government and private sector, in order to become stronger they have to be given more opportunities to perform, including the opportunity to make mistakes.
- *Traditional USG representatives too often lack the local knowledge necessary to support business activity.* Business is driven by and operates according to local

practices, from the bottom up. The U.S. effort needs to be more open to helping Afghans use their own rules of commerce.

- *There are plenty of Afghan entrepreneurs, the constraint is limited capital. Co-investing alongside Afghan capital is less risky and more successful because Afghans' own money is at risk. Consequently we need to find a way to connect international capital with Afghan entrepreneurial ideas. An enterprise fund should be considered (although the U.S. has implemented them less than optimally elsewhere).*
- *Inefficient and overly burdensome Afghan government red tape impedes business. Property titling is incoherent, taxes are too high, the High Commission for Investment is not meeting regularly, and the government is not doing enough to develop natural resources.*
- *We should provide more support of Afghan education and training, in and out of country. This is the investment sure to produce high and lasting returns.*

Assistance that Supports Legitimacy and Sustainability

If the two basic problems with past assistance have been insufficient alignment with Afghan priorities and institutions and the tendency among international donors toward fragmentation, one might describe the challenge of more effective assistance simply as finding approaches that organize international donor efforts around Afghan priorities and institutions. While that could in theory be accomplished by some kind of international coordinating body granted extraordinary authority sufficient to coordinate sovereign donors – authority UNAMA has never had – when we recall the central importance of the crisis of government legitimacy, however, it becomes impossible to avoid the conclusion that bolstering Afghan legitimacy requires an approach in which the Afghan government itself is responsible for this function.

To restate this in terms of the governance and economy dimensions of the legitimacy crises discussed earlier: the governance element of the legitimacy crisis will be sustainably resolved only when it is the government that is performing basic governmental functions, and the economic element of the legitimacy crisis will be sustainably resolved only when economic and business decisions are made by Afghan officials and Afghan businesspeople.

The objective of U.S. assistance, then, must be to support, and not undermine, sustainable resolutions of each of these elements of the legitimacy crisis. As World Bank President Zoellick recently wrote, “To achieve legitimacy, it is not only the services that matter, but who performs them: they should be undertaken by the government and local people as soon as is feasible. This strategic consideration should guide both the handoff from humanitarian aid to development and the design of transition services.”

I think an allied point was made by General McChrystal last month (as reported in the June 20th New York Times) when he suggested adding to the traditional counterinsurgency

formula of “clear, hold, build” a fourth element: “sustain”. If the requirement to “hold” sometimes constrains international military forces from acting directly in “clearing” until local security forces are ready to “hold”, the requirement to “sustain” may be interpreted as a similar constraint on international civilians from acting directly in “building” until it has been established that there is Afghan interest and capacity to “sustain” the initiative. In practice, this will usually mean that the Afghans have to be brought in on the original “build” decision.

Elements of a More Effective, Legitimacy-Focused Approach to Assistance

What does this mean in practice? As Patrick Cronin, Director of the Institute for National Security Studies, noted in his testimony for this Subcommittee’s hearing on May 19, my colleagues Dawn Liberi, Clare Lockhart and I have outlined a strategic concept for more effective development, economics and governance assistance to Afghanistan that is based on three pillars:

- Afghan public finance, especially budgets, as a focal point for our efforts to support improved Afghan governance and state functioning;
- Key sector roadmaps, developed jointly with Afghans and designed to reflect Afghan priorities and capacities (on the general model of the National Solidarity Program), to develop programs worth receiving funding; and
- Catalytic financial instruments (e.g., guarantees, risk insurance) as a focal point for our efforts to support the development of the Afghan private sector and economy

I will now briefly explain why each pillar of this concept should be better able to avoid the pitfalls of past assistance to Afghanistan described above and capable of making a significant contribution to a sustainable resolution of key elements of the underlying legitimacy crisis.

Public budgets, and public finance in general, are linchpins of public governance in all states. Budgets are how governments rank and tradeoff priorities and signal policy commitments. Once a budget is agreed, budget execution is how money flows to all legitimate priorities of the state, from paying the salaries of soldiers, police and teachers to making capital investments in schools, hospitals and roads. As such, Afghan budgets – at both the national and subnational levels – have the potential to be a uniquely authoritative and comprehensive statement of Afghanistan’s own objectives. By embracing Afghan budgets and Afghan institutions for public finance as focal points for U.S. assistance efforts, we would avoid the longstanding problem of our efforts being misaligned with Afghan priorities and institutions. Instead, Americans would largely be in the position of helping Afghans implement their priorities, which would both bolster government legitimacy and increase the chances that the Afghans will sustain initiatives started when we are ready to scale down our presence. At the same time, because there is only one Afghan budget for any particular governmental unit (e.g., nation, village), such a focus could effectively address the international fragmentation problem by binding all international

assistance to a single set of Afghan priorities and institutions. Among other virtues, adopting this approach could provide most Americans working on the civil side in Afghanistan (whether civilian or military) with the kind of simple, clear and nearly universal conception of their mission in Afghanistan that has until now stymied the effort: we are assisting the Afghans with their priorities as documented in their budgets, by helping them with any and all steps necessary under their institutions to execute those budgets. We should not underestimate either the value of a clear mission or the difficulty of imposing one on a fragmented effort after the fact. However, I believe that one lesson from Iraq applicable to Afghanistan is that a focus on local public finance and budget execution (an approach adopted in Iraq in early 2007 that continues successfully to this day) is one of the few demonstrated sources of such a unifying mission. Finally, because budget execution is fundamentally about spending money, our efforts to help the Afghans push money through their public finance system will stimulate the Afghan economy via channels more sustainable than those currently used for the large majority of international assistance spent via donor-specific parallel systems – namely public sector salaries that Afghan individuals and families rely on for buying power and public capital expenditures that can provide contracts for Afghan private companies and workers.

To implement this would require (1) a priority commitment throughout the U.S. effort (civilian and military) to working with the Afghans to understand and strengthen Afghan public financial management systems at all levels of government (together with other international actors already active in this area such as the World Bank), (2) serious discussions with the Afghan national government about introducing more fiscal decentralization and empowering at least some subnational authorities (e.g., provincial councils) with budgetary authority (supplementing, not replacing, the current national budget system) and (3) a willingness to provide a greater proportion of U.S. assistance as budget support. While the last point has sometimes been viewed as controversial, I believe there is an emerging consensus in favor of its utility among both Afghanistan experts (e.g., the Asia Society's recent report on stabilizing Afghanistan-Pakistan) and public finance experts (e.g., recent World Bank research concluding that the case for budget support is strong in high-capacity and low-capacity reform settings alike).

The second pillar of this strategic approach is the collaborative design with relevant Afghan experts of roadmaps setting out high-impact programs in key sectors (e.g., agriculture, education, health, electricity, justice). While these roadmaps would be developed at the national level, individual programs will aim to exploit capacity wherever it exists, including all the way down to the village level (e.g., National Solidarity Program) and in non-governmental organizations. Rather than being an attempt at wholesale reengineering of the Afghan state, these sector roadmaps would be designed from the outset to reflect Afghan priorities and institutional capacity.

The final pillar of this strategic approach is a greater emphasis on catalytic financial instruments such as partial loan guarantees, risk insurance and microfinance that by their nature

bolster, rather than substitute for, bona fide Afghan businesses. I have already noted the Afghan business view that the binding constraint is not enterprises but capital to expand them and the eagerness to invest Afghan money in conjunction with international capital, credit enhancement or risk mitigation. Like the other pillars, this approach links international assistance to Afghan (business) priorities and institutions (enterprises), limiting any international donor temptation to invest money in private sector ventures with insufficient Afghan support and willingness to sustain.

The Way Ahead

What would be required for the U.S. to implement such a legitimacy-focused, three pillar strategy for governance and economic assistance to Afghanistan? A number of elements of the strategic concept are already implicitly or explicitly part of the President's new strategy for Afghanistan. In closing, I'd make just two final recommendations about communicating a clear and coherent approach throughout the U.S. effort.

First, leaders in the Administration and Congress should explicitly signal that the centrality of Afghan legitimacy to the current emergency situation requires that U.S. assistance be extraordinarily oriented toward supporting, and not undermining, Afghan legitimacy, even if this requires departures from normal foreign assistance modalities and the acceptance of greater than usual fiduciary risk. U.S. assistance efforts must support the Afghan government performing governmental functions, and Afghan officials and businesspeople leading on economic and business decisions.

Second, and making this general point concrete, all relevant U.S. officials should embrace Afghan budgets/public finance as the key civil-side framework for achieving this Afghan legitimacy focus. Both the legislative steps in Washington and the technical steps in Kabul required for a greater use of budget support should be a priority. New structures to coordinate the U.S. effort more closely with public finance experts at the World Bank and the IMF should be established. The focus on Afghan budgets should be a major theme of the training for all U.S. military and civilian personnel deploying, with an explicit objective of seeking to counter the temptation to do directly things better done indirectly (i.e., by working by, with and through Afghans). Data about budget-related assistance efforts – not how much we are spending, but how much we are helping them spend – should be made a key part of the metrics used to track the U.S. effort. Senior policy officials responsible for spearheading the public finance thrust should be designated both in Washington and Kabul. In sum, the entire U.S. effort – in Washington and the field, civilian and military – should explicitly adopt Afghan budgets/public finance as a central strategic focus, in the interest of the broader objective of bolstering Afghan legitimacy and thus achieving sustainable stability as quickly as possible.