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The Economic Shock to Afghanistan Caused by Aid Reduction and Troops Withdrawal

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Jawid Ahmad Nasery

THE ECONOMIC SHOCK TO AFGHANISTAN
CAUSED BY AID REDUCTION AND TROOPS
WITHDRAWAL



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Jawid Ahmad Nasery

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BY AID REDUCTION AND TROOPS WITHDRAWAL**

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This Paper “The Economic Shock to Afghanistan Caused by Aid Reduction and Troops Withdrawal” is the first part of my M.Sc. thesis submitted to the Management and Economics Faculty of the Ruhr-University Bochum, which aims to analyze, quantify and describe the economic shock caused by the adjustments in international aid, as well as the troops withdrawal, on the Afghan economy in terms of GDP per capita growth, employment, investment and business climate and state deficit.

In the second paper “Present Perception, Future Priorities and Socioeconomic Characteristics: Afghan Households and International Assistance” the perceptions, priorities and expectations of Afghan households regarding international aid flows are evaluated and described. The paper also analyses the socioeconomic characteristics of the households for future policy recommendations.

For a better understanding of the topic and narrative it is kindly recommended to read the first paper before reading the second paper.

CONTENTS

List of Figures.....	iv
List of Tables.....	v
Abbreviations.....	vi
1 Introduction.....	I
1.1 Objectives of the Study, Research- Questions and Methodology.....	2
1.2 Organization of the Study.....	3
2 The History of Foreign Aid.....	5
2.1 Establishment Phases of Development Corporation (1944-Present)	7
2.1.1 The Initiation Phase (1944-1959)	7
2.1.2 The Institutionalization Phase (1960-1970).....	8
2.1.3 The Development Phase (1970-Present).....	9
2.2 Post Conflict Aid.....	9
3 Foreign Aid to Afghanistan.....	II
3.1 Economic Growth of Afghanistan from 1971-2011	12
3.2 Determinants of Development Aid to Afghanistan and other PCCs.....	15
3.2.1 Hypothesis and Data	17
3.2.2 Implication for Afghanistan and other SCACs	19
3.3 Post-Taliban Aid to Afghanistan (2002-2011)	20
3.3.1 Official Development Assistance Spent on Afghanistan	22
3.3.2 Security Aid Spent on Afghanistan	25
3.4 Foreign Aid Spent on and in Afghanistan.....	26
4 The Economic Shock to Afghanistan.....	29
4.1 The Shock to Economic Growth.....	29
4.1.1 Regression Results Based on Solow Model	29
4.1.2 GDP Growth and Vicious Circle.....	33
4.1.3 Emergence of the Vicious Circle and FDI	33
4.2 The Shock to Fiscal Budget.....	36
4.2.1 Revenues of Core Budget	36
4.2.2 Sectoral Allocation of Development and Operation Budget.....	38
4.2.3 Lack of Absorption Capacity	41
4.3 Shock Caused by Withdrawal of Troops	42
4.4 The Shock Caused by Expectation.....	45
5 Conclusion	49
Bibliography.....	53
Annexes.....	61

LIST OF FIGURES

Fig. 1:	Total Allocation of ODA	6
Fig. 2:	Average ODA/GNI- and ODA Percentage Ratio of DAC Members.....	8
Fig. 3:	HDI of Afghanistan with the Rest of the World	13
Fig. 4:	Structure of the Foreign Aid to Afghanistan.....	21
Fig. 5:	ODA to Afghanistan.....	22
Fig. 6:	A Comparison of ODA per Capita Commitments with Bosnia and Iraq ...	24
Fig. 7:	Sectoral Allocation of Bilateral ODA.....	24
Fig. 8:	Approximated Security Aid Disbursements in Million.....	25
Fig. 9:	Sectoral Allocation of Security Aid.....	26
Fig. 10:	Opium Cultivation from (1999-2012), Source: UNODC, (2011).....	31
Fig. 11:	Net Export Value of Opiates and GCF to GDP.....	32
Fig. 12:	The Vicious Circle in Afghanistan.....	33
Fig. 13:	Major Business Challenges	34
Fig. 14:	FDI as a percentage of GDP	35
Fig. 15:	Development and Operation Budget Execution Ratio.....	37
Fig. 16:	Sectoral Allocation of Operation Budget	38
Fig. 17:	Sectoral Allocation of Operation Budget	39
Fig. 18:	Number of Public Sector Employees in Different Sectors.....	39
Fig. 19:	Contractors by Type of Services in Iraq.....	43
Fig. 20:	Annual Growth of House Prices in Kabul.....	46
Fig. 21:	Effects of Withdrawal of Foreign Troops on Economy.....	46

LIST OF TABLES

Tab. 1:	Categorization of Countries on the Basis of GNI per Capita	5
Tab. 2:	Average Growth of Real GDP and Population during considered periods.....	12
Tab. 3:	Some of the Main Economic Indicators.....	14
Tab. 4:	Corruption and Security Indexes.....	15
Tab. 5:	List of SCACs	16
Tab. 6:	Regression Output, Dependent Variable ODA per Capita	18
Tab. 7:	Domestic Spending Ratio of On-budget and Off-budget ODA and Security Aid	26
Tab. 8:	Domestic Spending Ratio of Off-budget ODA and Security Aid	27
Tab. 9:	Domestic Spending Ratio of On-budget ODA and Security Aid.....	27
Tab. 10:	Total Spending Ratio of ODA and Security Aid	27
Tab. 11:	Regression Output Dependent Variable: GDP per Capita Growth, N = 9	30
Tab. 12:	Regression Output Dependent Variable: GDP per Capita Growth, N = 9	30
Tab. 13:	Farm Gate and Export Value of Opium to GDP.....	32
Tab. 14:	Correlation between ODA Security Aid and FDI	35
Tab. 15:	Core Budget (Operation, Development and Grants).....	36
Tab. 16:	Population, Labor Force and Employment	40
Tab. 17:	Correlation between Real GDP per Capita Growth, Domestic Revenues and Government Employees	40
Tab. 18:	Estimated Afghan Employees by Type of Service with Foreign Troops	45

ABBREVIATIONS

ACs	Armed Conflicts
CEEC	Conference for European Economic Co-operation
CERP	Commander Emergency Response Program
CSR	Conflict Severity Ratio
DA	Development Aid
DAG	Development Assistance Group
DCs	Developing Countries
DR	Dispersion Ratio
FA	Foreign Aid
FDI	Foreign Direct Investment
GCF	Gross Capital Formation
GNI	Gross National Income
GNP	Gross National Product
HD	Harrod-Domar
HDI	Human Development Index
IMF	International Monetary Fund
LICs	Low Income Countries
LDCs	Least Developed Countries
LMICs	Low Middle Income Countries
MDGs	Millennium Development Goals
MP	Marshall Plan
MSA	Mutual Security Agency
NATO	North Atlantic Treaty Organization
NGOs	Non-Governmental Organizations
ODA	Official Development Assistance
OEEC	Organization for European Economic Co-Operation
OECD	Organization for Economic Cooperation and Development
OOF	Other Official Flows
OLS	Ordinary Least Squares
OT	Overseas Territories
OTC	Overseas Territories Committee

PCA	Post Conflict Aid
PCCs	Post Conflict Countries
PCER	Post conflict Economic Reconstruction
PCYs	Post-Conflict years
SCACs	Severely Conflict Affected Countries
UMICs	Upper Middle Income Countries
UN	United Nations
WB	World Bank
WBDI	World Bank Development Indicators

1 INTRODUCTION

Foreign Aid (FA) is defined as financial flows, technical assistance and commodities that are (a) administered with the promotion of the economic development and welfare (thus excluding aid for military or other non-development purposes); and (b) are provided as either grants or subsidized loans.¹ In the context of development economics, the aid targeting the objectives of FA and similar is called Development Aid (DA).

Since the foundation of the World Bank and the United Nations (UN) in 1944 and 1945 respectively, economic development has become a main topic of international relations and development studies.² Issues concerning economic growth and development are the main focus of international development organizations. The Marshal Plan (MP) allowed Europe to achieve high levels of economic growth and development. Additionally the successful implementation of the MP raised hopes for the elimination of hunger, poverty and under-development in Developing Countries (DCs). The MP convinced many economists, that economic growth and development in DCs can be realized in a similar fashion.³ They drew attention to the hidden potential of DCs which can be utilized with the assistance of donor countries. In the years 2006-2010, donor countries allocated on average annually 120\$ billion⁴ in the form of DA to DCs.⁵

Afghanistan is one of the Least Developed Countries (LDCs) and has been a recipient of DA since 1950. The previously unprecedented levels of economic growth achieved in the last two decades of the 20th century enabled many countries to achieve economic development and higher standards of living. Not only did Afghanistan see progress but the country, and its population, was subjected to some of the harshest living conditions on the planet. Afghanistan became one of the major battlefields of the Cold War; the war with the Soviet Union started in December 1979 and lasted until February 1989. This war was followed by a severe civil war between different groups of Mujahidin and later between them and the Taliban, which continued until November 2001. The war cost the nation two million lives, one million disabled and about three million refugees.⁶ In this period Afghanistan lost 240\$ billion in ruined infrastructure and foregone economic opportunities.⁷ From 1979 to 2001 the country had, on average, a negative real GDP growth rate of 2.54 percent.⁸

The 9/11 attacks marked a fundamental shift in donors' approach to Afghanistan, many countries particularly the United States (US) realized that the deployment of their troops and DA are indispensable to ensure their security interests. For the accomplishment of the mentioned purpose, after the downfall of the Taliban by the US in the end of Novem-

1 OECD (2011); Radelet (2006), p. 3.

2 Hjertholm and White (2000), p. 5.

3 Cypher, et al. (2009), p. 140.

4 The currency unit of the figures throughout the thesis is the United States Dollar denoted by (\$).

5 OECD Statistics (2013).

6 Alim and Sharif (2002), p. 1.

7 Ghani and Lockhart (2009), p. 75.

8 See Section 3.1.

ber 2001, donor countries deployed their troops⁹ and substantially increased the amount of aid to Afghanistan. From 2001-2011 donor countries allocated 70\$ billion (32 billion development and 42\$ billion security aid) to Afghanistan.¹⁰ The number of foreign troops in 2011 exceeded 130 thousand.¹¹

For the first time since the beginning of the war with the Soviet Union, due to the major involvement of international community (member countries of North Atlantic Treaty Organization (NATO), other donor countries, international development organizations such as the UN and the World Bank) the momentum of negative GDP growth has reversed. From 2002-2011 the real GDP growth has significantly increased, on average by 9.27 per cent.

Nine years afterwards, in the year 2010/2011, donors announced the withdrawal time-plan of their troops, beginning in the year 2011 until 2014.¹² The annual amount of total aid pledged for the years 2012-2016 to Afghanistan has significantly decreased compared to the total amount disbursed in the years 2010 and 2011. The total aid disbursed in the years 2010 and 2011 was 11\$ and 13\$ billion respectively¹³, the annual total aid pledged for the years 2012-2016 is 8\$ billion. Compared to the average figure of the years 2011 and 2012 (12\$ billion) the pledges of aid have decreased about 33 percent.¹⁴ The withdrawal of foreign troops and reduction of development and security aid pose essential challenges for the economy of the country. The uncertainty about the future aid flows has dramatic impacts on economic activity and business environment.

1.1 Objectives of the Study, Research- Questions and Methodology

The objective of this study is to examine the determinants of DA to Afghanistan and to analyze the impact of development and security aid on GDP per capita growth of Afghanistan. The pledges, disbursements, and sectoral allocation of development and security aid are investigated and the potential employment effect caused by the withdrawal of foreign of troops is estimated. In addition this study describes the main problems hindering the effectiveness of aid in the country. One of the aims of the study is to deliver the voice of the people to international community, donors, the government and all other individuals who have contributed to the development of the country.

The empirical part of the study tries to find answers to the following questions:

1. What are the determinants of DA to Afghanistan?

9 The deployed troops to Afghanistan are mostly troops of NATO member countries. See Annex 3.

10 See Section 3.3.

11 Livingston and O'Hanlon (2011), p. 5.

12 Hussain and Soherwordi (2012), p. 129, BBC. (2010).

http://news.bbc.co.uk/2/hi/south_asia/8485861.stm and CNN. (2011).

<http://edition.cnn.com/2011/POLITICS/06/22/afghanistan.troops.drawdown/index.html>.

13 Ministry of Finance (2012), p. 10.

14 Ibid. p. 2.

2. Have development and security aid contributed to economic growth of Afghanistan?
3. What are the impacts of aid reduction on the government's budget?
4. What are the main factors hindering the effectiveness of aid in the country?
5. What are the economic impacts of the withdrawal of foreign troops on the Afghan economy?

Research Methodology

For the determinants of aid to Afghanistan the Seemingly Unrelated Regression (SUR) method is applied. The variables of the model are based on the empirical literature and findings of this study. For the analysis of economic growth, the neo-classical growth model of Solow-Swan is applied and estimated with Ordinary Least Squares regression. The Solow-Swan growth model studies the relationships of savings, investments, population growth, technological change and output with economic growth.

The descriptive analysis is based both on primary and on secondary data. The primary data was collected through a survey of real estate property dealers in Kabul to measure the current state of the market.

To the extent of my knowledge, this research is the first of its kind and provides a valuable input to the debate of determinants of aid to Post-Conflict Countries (PCCs), effectiveness of aid in PCCs and post conflict economic development.

1.2 Organization of the Study

The study is organized in seven parts. The first part contains a brief introduction of the study which includes the objective of the study and the research questions. The second part discusses the historical evaluation of development corporations and its scope of operations. The third part empirically analysis the determinants of aid to Afghanistan and other Severely Conflict Affected Countries (SCACs). The fourth part describes the history of FA to Afghanistan, it analyses the current state of aid (type of aid, volume, sectoral allocation and time profile) including the domestic spending ratios of aid. In the fifth part the neo classical growth model of Solow-Swan is applied to analyze the effect of development and security aid on real GDP per capita growth of Afghanistan. In addition the impact of aid reduction on government's budget is described and the impact of withdrawal of foreign troops on employment is analyzed.

2 THE HISTORY OF FOREIGN AID

The primary accords of FA in the history of mankind are unknown; throughout history territories and countries have delivered their assistance to each other for various purposes. In the context of development economics, aid aiming at the objectives of FA and similar is called DA. The defined goal of DA is to reduce poverty, supplement domestic savings, boost long-term investment and ensure sustainable economic growth. The aid flows to recipient countries include official aid flows by the governments, their agencies¹⁵ (bilateral aid) or multilateral agencies¹⁶ (multilateral aid) and private voluntary assistance (by non-government organizations (NGOs), religious groups, charity funds, foundations, and private companies). Official aid flows includes Official Development Assistance (ODA) and Other Official Flows (OOF).¹⁷ ODA consists of bilateral and multilateral official flows to recipient countries or territories delivered directly by the donor states, their agencies or multilateral agencies that is concessional in character and contains a grant element of at least 25 percent, calculated at a discount rate of 10 percent. OOF do not meet the conditions for eligibility as ODA either because they are not primarily aimed at development, or because they have a grant element of less than 25 per cent.¹⁸

Tab. 1: Categorization of Countries on the Basis of GNI per Capita

Income Category	Number of Economies	GNI Lower Limit	GNI Upper Limit
Low Income Countries (LICs)	36	<1,025	1025
Lower Middle Income Countries (LMICs)	48	1026	4035
Upper Middle Income Countries (UMICs)	55	4036	12475
High Income Countries (HICs)	75	12476	12,476<

Source: World Bank, Country Classification, (2013).

On average from 2000-2010 ODA contributed about 92 percent of the total official aid net disbursement to recipient countries. The share of bilateral and multilateral ODA was 74 and 26 percent respectively.¹⁹ There is no any single uniform definition of DCs that is internationally recognized, the World Bank categorized countries and other economies (Islands and etc. with at least population of 30,000) on the basis of Gross National Income (GNI) per capita into the following groups.

¹⁵ Agencies such as USAID of the US and GTZ of the Federal Republic of Germany.

¹⁶ There are more than 200 multilateral aid agencies, premier of them are the United Nations System of Organizations, World Bank, European Union (EU), Global Funds and other main development banks. OECD. See: <http://www.oecd.org/dac/aid-architecture/multilateralaid.htm>.

¹⁷ Radelet (2006), p. 4.

¹⁸ OECD (2010), pp. 11-12.

¹⁹ The average is calculated. See: OECD, Statistics (2013).

According to World Bank DCs include LICs and LMICs.²⁰ UN further classifies countries into a category of Least Developed Countries (LDCs). The classification in to LDCs is based on three criteria, Income Per Capita, Human Assets Index and Economic Vulnerability. In 2011 there were a total 48 of LDCs, 33 in Africa, 14 in Asia including Afghanistan and Haiti in Latin America, the list of LDCs is reviewed every three years.²¹

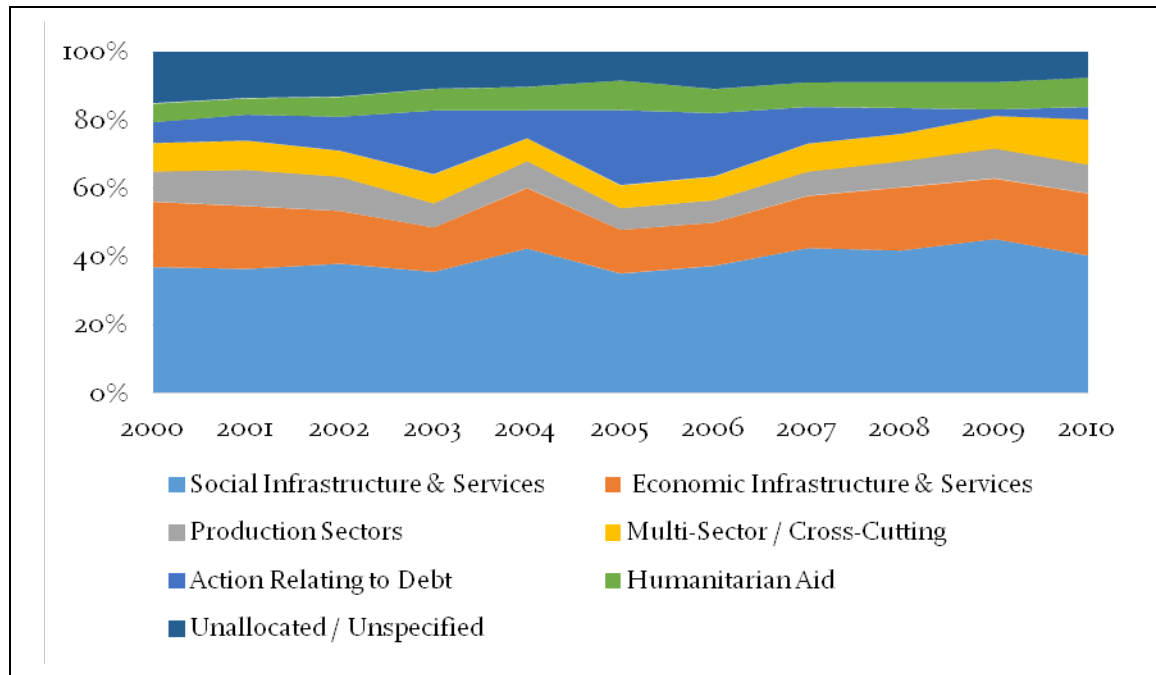


Fig. 1: Total Allocation of ODA
Source: OECD, Statistics, (2013).

The social infrastructure and services include the sectors: education, health, water supply, security, government, and civil society. The economic infrastructure and services include the sectors: transport, communication, energy, business and financial services. The production sector includes the sectors: agriculture, construction, fishing, mining and tourism. The higher amount of debt relief between 2004 and 2007 was because of the Multilateral Debt Relief Initiative proposal of G8 finance ministers to: the World Bank, African Development Fund and the International Monetary Fund (IMF) to cancel 100 percent of their debt claims on highly indebted poor countries.²² In the end of 2011, the total cost of the debt relief amounted to 76\$ billion.²³

²⁰ World Bank, 2013. See: http://data.worldbank.org/about/country-classifications/country-and-lending-groups#Low_income.

²¹ UN (2011), p. IV.

²² World Bank (2007), p. 1.

²³ IMF (2013), p. 3.

2.1 Establishment Phases of Development Corporation (1944-Present)

The background and historical evolution of the current globally established system of Development Cooperation are essential in order to understand its purpose and the scope of its operations. The background and the historical evolution will answer the following questions: 1) How did DA emerge and what were the motives behind its emergence? 2) Who are the main donors of DA and how much do they donate? 3) Which are the main organizations involved and what are the main issues encompassing DA? The modern history of the DA from 1944 can be divided into three phases: Initiation Phase, Institutional Phase and Development Phase.

2.1.1 *The Initiation Phase (1944-1959)*

The roots of the current established system of development cooperation go back to the end of World War II when, in the years 1944 and 1945, international organizations such as World Bank and UN were formally founded. On June 5th, 1947 the US Secretary of State George C. Marshall initiated the European Recovery Program subsequently known as the MP,²⁴ which has become known as history's most successful structural adjustment program.²⁵ In the framework of MP from 1948 to 1952, the US channeled 13\$ billion — equivalent to 125\$ billion in the year 2013,²⁶ in economic and technical aid for reconstruction and economic growth in the form of grants, loans and conditional aid to 16 European countries.²⁷ In July 1947, 16 European countries held the Conference for European Economic Co-operation (CEEC) with the purpose to prepare a proposal for the MP. In April 1948, the “Convention for European Economic Co-operation” was signed by the foreign ministers of the CEEC countries.²⁸ Through Article I of the convention, the Organization for European Economic Co-Operation (OEEC) was founded.²⁹ In the article II of the convention it was stated that the development of production under the MP included the mobilization of the resources of the Overseas Territories (OT) of the signatories. The Overseas Territories Committee (OTC) was founded by OEEC to carry out surveys relating to the economic and social development of the OT. The potential of OT as major sources of income had to be realized through the export of raw materials to the US and by European exports to OT.³⁰ For the accomplishment of the mentioned purposes; almost six per cent of the total distributions under the MP were channeled to the OT of the European beneficiaries.

24 OECD. Edit. Griffiths (1997), p. 3.

25 De Long and Eichengreen (1991), pp. 1-3.

26 The present value is calculated using the Consumers Price Index of the US, the base year is 1950. Areppim (2013) See: http://stats.areppim.com/calc/calc_usdlrxdeflxcpi.php.

27 Sorel and Padoan (2008), p. 5.

28 OECD. Edit. Griffiths (1997), p. 34.

29 Ibid, p. 35.

30 Ibid. p. 34 and 87. OT is referred to any territory which is mainly under the political influence (colony) of another country. Note, that not all of OEEC members had OT.

2.1.2 The Institutionalization Phase (1960-1970)

In 1960 the Undersecretary of the US Douglas Dillon proposed an increase in the flow of DA to developing countries and demanded the creation of an institution for its coordination.³¹ For this purpose the Development Assistance Group (DAG) —whose membership was not only limited to colonial powers— was created and recognized by the OEEC ministers, subsequently other countries joined OEEC.³² In 1960, the OEEC was transformed into the Organization of Economic Cooperation and Development (OECD); the OTC merged with the DAG in December 1961 to form the Development Assistance Committee (DAC) of OECD.³³

The simultaneous developments which paved the way for the flow of some of the DA to DCs without the whole discretion of colonial powers were: the enhanced integration in Europe and its uniform foreign policy; the expansion of the UN activities on a global platform and the appeal of the World Council of Churches upon developed countries to donate one percent of their GNI as DA to developing countries. However in a UN resolution on October 24th 1970, the DAC member generally agreed on 0.7 per cent of GNI as DA.³⁴ The US has ODA/GNI ratio of only 0.21 percent, but it is the largest ODA provider with average ODA share of 23 per cent among the DAC member countries, followed by Japan, Germany, United Kingdom (UK) and France with ODA shares of 13, 10, 10 and 9 per cent respectively.

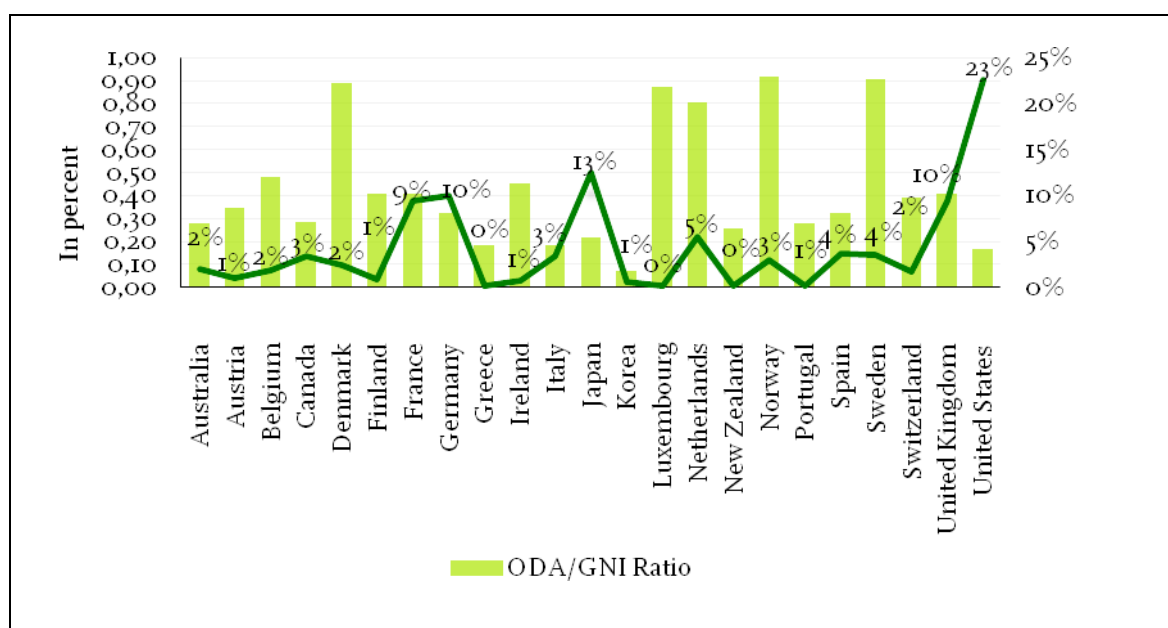


Fig. 2: Average ODA/GNI- and ODA Percentage Ratio of DAC Members
Source: OECD, Statistics, (2013).

³¹ Ibid. p. 94.

³² Ibid. p. 96. The member countries of DAG were Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Portugal, the United Kingdom and the US.

³³ Ibid. p. 94.

³⁴ OECD (2011), p. 10.

Only five countries have reached or exceeded the target of 0.7 per cent, namely: Norway, Sweden, Denmark, Luxembourg and the Netherlands with average ODA/GNI ratios of 0.92, 0.9, 0.89, 0.87 and 0.81 per cent respectively.

2.1.3 *The Development Phase (1970-Present)*

In the development phase the focus of the efforts has been on trying to find a framework of best practice which will accomplish the main goal of DA. Premier issues during the development phase have been: the volume of aid, untying of aid, fair trade, gender equality, recipients centered aid, effectiveness of aid and better coordination among donors and recipients. From 1980, an interdisciplinary approach has been adopted with the focus on: state building and institutional reforms, the promotion of the civil society and the encouragement of the private sector.³⁵ The major events in the development phase have been the UN Millennium Summit, which was held in September 2000 to commit the world's nations to a new global partnership to achieve a series of time-bound development targets, which have become known as the Millennium Development Goals (MDGs), which eventually evolved from a jointly published report (A better World for all) by the IMF, OECD, UN and the World Bank in June 2000.³⁶

2.2 Post Conflict Aid

Post Conflict Aid (PCA) is different from conventional DA, the most notable difference stems from the environment in which PCA is disbursed. In PCCs, PCA has two primary objectives; a humanitarian and a reconstructive one.³⁷ The humanitarian objective is mainly concerned with the survival issues: ensuring minimum levels of consumption, providing shelter to displaced people and managing the return of refugees. The reconstructive objective, in a broader sense, targets the rehabilitation of physical and human infrastructure, the provision of basic services, adoption and enforcement of structural policies and creation of sound business environment for private sector development and market based economy to achieve economic growth. The accomplishment of economic growth and other above mentioned objectives, considering the country related factors (pre- and post-socioeconomic and geopolitical circumstances), the conflict related factors (causes, forms,³⁸ scope (internal/external), duration and severity) of conflicts and the aid related factors (quantity, time-profile, and composition) require an individual-analysis, defined-expertise, prudent-policies and a proactive action plan.

In the decade that followed the end of the Cold War, civil conflicts multiplied and international support to PCCs gradually increased. This focus was given further impetus within

³⁵ OECD (2011), pp. 15-40.

³⁶ Paris21 (2013), See: http://paris21.org/better_world-for-all.

³⁷ Demekas, et al. (2002), p. 3.

³⁸ The form of the war refers to different types of wars such as insurgency, guerilla war and terrorism. See: <http://usiraq.procon.org/sourcefiles/InsurgentsvsTerrorists.pdf>.

the framework of the MDGs and following the events of 9/11: PCCs have received increasing attention and more ODA.³⁹ Most of the research on PCCs has been done under the scope of fragile states; three out of four PCCs are classified as fragile states. In Fragile states, ODA is the largest financial inflow followed by remittances and Foreign Direct Investment (FDI).⁴⁰ From 2000-2010, average per capita ODA to fragile states grew by half in constant term, Debt Relief Initiative was a major contributor to that increase.

The most daunting challenges faced by our world today in the context of reducing poverty, human suffering and achieving the development goals are Armed Conflicts (ACs) and their consequences.⁴¹ ACs not only cause humanitarian catastrophes such as: deaths, injuries, handicaps, diseases, despair and psychological trauma, but also sabotage the economy. It destroys infrastructure and institutions, disrupts/distorts investment and saving decisions and displaces labor. Civil wars have dramatic effects on GDP growth; during war period the GDP growth decreases 2.2 percent annually.⁴² The total deaths caused by conflicts from 1945 to 2,000 with at least 1,000 casualties are estimated to be approximately 41 Million.⁴³ In the late 20th century, civilian casualties accounted about 75 to 90 percent of the total casualties compared to only 10 percent a century ago.⁴⁴ Children and women account about 75-80 percent of total conflict refugees.⁴⁵ PCCs face an alarmingly high risk of reversion to conflict; the estimated risk of sinking back into a violent conflict over a decade is estimated to be 40 percent.⁴⁶ The key challenge of a transition from conflict to peace is to prevent the recurrence of war. Inadequate mandates, insufficient expertise, poor governance and lack of legitimacy have been present to different degrees, in all recent conflict to peace transitions.⁴⁷ In PCCs a successful transition in security and economic sector is a prerequisite for rehabilitation and development.

39 OECD (2013), *Fragile States*, p. 15.

40 Ibid. p. 43.

41 OECD (2011), p. 3.

42 Collier (1999), p. 181.

43 Leitenberg (2006), p. 79.

44 Epps (2011), pp. 19-20.

45 Stanford University. http://humanexperience.stanford.edu/women_conflict-murray.

46 Collier, et al. (2006), p. 7.

47 Castillo (2009), p. 15.

3 FOREIGN AID TO AFGHANISTAN

The history of FA⁴⁸ to Afghanistan can be traced back to 1857, when it first received monetary assistance from the East India Company during the British rule in South Asia.⁴⁹ Afghanistan being a least developed and Land Lock Country (LLC) has been dependent on international aid for decades prior to the war. Overall, LLCs are worse off than their neighbors in each component of HDI. The average GDP per capita of LLCs is approximately 57 percent of their maritime neighbors, life expectancy is 3.5 years lower, education index scores are 0.36 points lower, and progress in many landlocked developing countries has also been slow.⁵⁰ Foreign assistance has played an important role in Afghanistan's history and economy. In the 1960s FA accounted for more than 40 percent of the state budget.⁵¹ Though from the late 1950s to the 1970s Afghanistan received multi-lateral ODA from the World Bank and the Asian Development Bank; however 80 percent of the foreign assistance to Afghanistan was determined by the cold-war. In the mentioned period Afghanistan received 50 percent of aid from the former Soviet Union, and 30 percent from the USA, which included approximately 160\$ million commitments in the form of loans.⁵² During the Soviet invasion, the flow of Soviet assistance to the country got further momentum, which helped to develop infrastructure, boost trade opportunities and cover fiscal deficit.⁵³ Notably, the Soviet assistance to Afghanistan in 1980 was one billion dollars, equivalent to 2.82\$ billion in the year 2013.⁵⁴ During the invasion, informal components were introduced into the formal economic structure. The informal economy was promoted with case and in-kind assistance from neighboring countries, USA and allies to the Mujahidin and refugees. The Russian official inflow of assistance to Afghanistan and other assistance of US and its allies stopped in the aftermath of Russian withdrawal (end of Cold War), which marked the beginning of severe civil war in the country.⁵⁵ From 1991-2000 small scale humanitarian assistance from Non-Governmental Organizations (NGOs) and UN agencies continued, the average annual net ODA to Afghanistan in the mentioned period was 106\$ million.⁵⁶

The post-Taliban era has been a turning point in the economic history of Afghanistan, total PCA committed from December 2001 to end of 2011 equals to 85\$ billion, the disbursed/spent amount equals to 70\$ billion.⁵⁷ The 9/11 attacks marked a fundamental shift in the donors' approach to Afghanistan, many countries, particularly the United States (US), realized that the deployment of their troops and development aid are indis-

48 Concerning Afghanistan, FA refers to total inflow of aid i.e. aid for development and other purposes such as security and etc.

49 Aitchison (1933), p. 233.

50 Faye (2004), p. 33.

51 Goodhand (2002), p. 841.

52 Ministry of Finance, (2010). p. 6.

53 Ibid. p. 7.

54 Ibid. The actual value is calculated using the Consumers Price Index of the US. Areppim. http://stats.areppim.com/calc/calc_usdlrxdeflxcpi.php

55 Ministry of Finance (2012), p. 7.

56 OECD, Statistics, (2013).

57 Ministry of Finance. (2012), p. 9. For aid allocation by donors see annex: 12.

pensable to ensure their security interests. Acknowledging the mistakes made after the Soviet withdrawal, in Bonn conference (December 2001), the international community expressed its strong commitment for democracy and development of the country. In the conference the Afghan Interim Authority was formed, succeeded by two years of transitional authority and subsequent elections in 2004.

3.1 Economic Growth of Afghanistan from 1971-2011

Because of the war (1979-2001) Afghanistan lost 240\$ billion in ruined infrastructure and foregone opportunities.⁵⁸ The war cost the nation 2 million lives, 1 million disabled and an estimated 3 million refugees.⁵⁹ In this period the country had a negative real GDP growth rate of 2.54 percent. Though Afghanistan was categorized in 1971 by the UN as an LDC, but the war took every possible opportunity, that would have enabled it to progress from the category of LDCs as other countries did.⁶⁰ Table (2) shows the real growth rate of some of main macroeconomic indicators from 1970 to 2011, the base year is 1971. The table is listed according to the main events and their duration.

Tab. 2: Average Growth of Real GDP and Population during considered periods

Period	Real GDP Growth	Real GDP per capita Growth	Population Growth
1971-1978 (Pre-war)	0.72	-1.72	2.48
1979-1989 (Soviet Invasion)	-1.61	-3.8	2.27
1990-2001 (Civil War)	-3.39	-6.06	3.06
2002-2011 (Post 9/11)	9.27	6.25	2.84

Source: Author's Calculation, Compiled from SESRIC Statistics, (2013) and World Bank, WBDI, (2013).

The Pre-war period was marked by decline in real GDP per capita growth, characterized by severe droughts, low agricultural output, and a centralized economy, which hampered private investment.⁶¹ The average real GDP growth of 0.72 percent in the pre-war period acknowledges the fact that the population growth was higher than the real GDP growth resulting in a negative real per capita growth rate of 1.72 percent; however due to inflation the nominal GDP growth rate in the mentioned period was on average 8.73 percent. The economic indicators and the fate of the country got worse with the Soviet invasion and the negative development continued until the fall of the Taliban. Empirical studies show that

⁵⁸ Ghani and Lockhart (2009), p. 75.

⁵⁹ Alim and Shobair (2002), p. 1.

⁶⁰ Hawthorne (2013), p. 141.

⁶¹ Ministry of Finance (2010), p. 6.

on average a negative 5 percent GDP growth rate increases the probability of a major civil war (with at least 1,000 deaths) to 50 percent.⁶² The same was the case with Afghanistan, in 1991 the real GDP growth rate was minus 10 percent and a year later in 1992 major civil war broke down, that continued until the fall of Taliban in November 2001. The civil war period so called Mujahedeen and Taliban period, had the worst effects on economy, in the mentioned period the average real GDP growth rate reached almost minus 3.5 percent with average real GDP per capita growth rate of almost minus 6 percent. A main factor for the deterioration of the economy in the mentioned period was the unprecedented drought throughout the last half century. Estimations suggest that the drought heavily affected 3 to 4 million people, 700 thousand abandoned their houses in search of food, water and pasture; 300 thousand of them fled to neighboring countries and the rest were displaced domestically.⁶³ For the first time since 1978 because of the major involvement of international community and the resulting PCA to Afghanistan, the momentum of negative development has reversed. From 2002-2011 the real GDP growth has significantly increased, on average 9.27 percent. The economic growth has positively affected the HDI in Afghanistan, increasing 0.14 points from the year 2000.

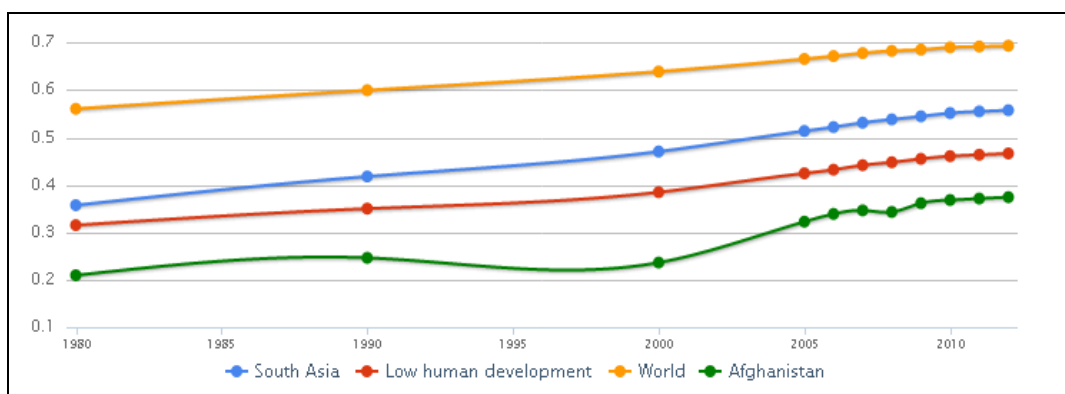


Fig. 3: HDI of Afghanistan with the Rest of the World
Sources: United Nations Development Program, (2013).

⁶² Miguel, et al. (2003), pp. 14-15.

⁶³ Alim and Shobair (2002), p. 1.

Tab. 3: Some of the Main Economic Indicators

Indicators/Year	2006	2007	2008	2009	2010	2011
Nominal GDP in \$ billion ^a	7.06	8.72	10.62	12.24	15.71	19.18
Real GDP growth in % ^a	5.04	13.65	3.02	21.06	17.26	8.14
Real GDP per capita ^a	155.37	171.1	172.2	202.2	230.3	243.2
Annual Consumer Price Index ^a	5.55	13.74	3.61	21.02	12.88	5.69
Sources: United Nations Development Program, (2013)						
<i>In percent of GDP</i>						
Exports of goods and services ^b	22.88	17.29	17.26	14.33	9.80	8.84
Import of goods and services ^b	64.02	56.59	46.3	41.02	43.92	38.79
Trade account balance	-41.14	-39.3	-29.04	-26.72	-34.12	-29.95
Revenues ^c	8.14	7.72	7.65	10.71	10.88	10.62
Expenditure ^c	22.15	22.65	21.13	22.11	20.84	21.53
Budget Deficit	14.01	14.93	13.49	11.4	9.96	10.92

Sources: a) World Bank, WBDI, (2013), b) SESRIC Statistics, (2013) and c) Ministry of Finance Budget, (2009, 2011).

Real GDP growth shows progress, but the high deviation is due to the fluctuations in agriculture share in GDP which is highly dependent on the rain fall. Trade account balance has improved, but the budget deficit remains a concern.

Tab. 4: Corruption and Security Indexes

Indexes/ Years	2003	2004	2005	2006	2007	2008	2009	2010	2011
Corruption Index ^a			31 (158)		7 (179)	2 (178)	2 (179)	3 (178)	4 (182)
Peace Index ^b						135 (138)	142 (143)	145 (148)	150 (153)
Terrorism Index ^b	13 (159)	9 (159)	4 (159)	3 (159)	3 (159)	3 (159)	3 (159)	3 (159)	3 (159)

Sources: a) Transparency International, b) Vision Humanity.

The economic growth has been accompanied by high corruption and insurgency/violence, as shown in Table (4) Afghanistan ranked in top three most corrupt countries from 2008-2010. The security situation measured by the peace and terrorism indices placed Afghanistan among the most insecure and violent countries.

3.2 Determinants of Development Aid to Afghanistan and other PCCs

The research results on the determinants of aid are sporadic i.e. they are mixed. Researchers generally do agree that FA is driven by altruistic (moral/humanitarian) and non-altruistic/personal (political, strategic and economic) motives. The altruistic motives are influenced by issues such as extreme poverty, child mortality rates and human rights; whereas the personal interest driven aid is influenced by concerns such as strategic interests, economic objectives, and political ties. Based on the empirical results it can be concluded that, amongst others, the determinants of aid are dependent on the form of aid (bilateral or multilateral) and the donors. Bilateral aid is to a large extent foreign policy driven; whereas multilateral aid is primarily concerned with development of recipient countries. Compared to other donors Nordic countries consider more the interest of the recipient countries.⁶⁴

To analyze the determinants of DA to Afghanistan a peer group of PCCs with similar war related characteristics is constructed and then the received DA is analyzed through OLS regression.

⁶⁴ See Lumsdaine (1993), Maizels and Nissanke (1984), Alesina and Dollar (2000), Bandyopadhyay and Wall (2006).

Construction of Peer Group

The peer group is constructed from the database of Leitenberg, which contains the list of PCCs from 1955-2000 with at least 1,000 war related military and civilian deaths.⁶⁵ The countries in the peer group are selected on the basis of following three criteria.

- The war in the peer group countries lasted continuously for at least five years with at least 50,000 civilian and military deaths. This condition ensures that SCACs are included in the group. It ensures a better comparison basis for the determinants of ODA.
- After conflict UN or NATO forces were deployed to peer-group countries (excluding military observation missions). This condition ensures the involvement of international community and its possible influence on ODA.

The ODA allocated to the peer group —exception of one year to Mozambique (1989) — was after the Cold War i.e. after 1989.⁶⁶ This condition controls that the ODA allocation is not influenced by the motives of Cold War.

The database of Leitenberg does not cover post 2000 years. Iraq⁶⁷ was included because it fulfills the above three conditions. The countries included in the peer group,⁶⁸ the war period, total casualties and the Conflict Severity Ratio (CSR) (total deaths in war period divided by average annual population during war period) of the peer group countries are given in the table (5).

Tab. 5: List of SCACs

Country	War begin year ^a	Major war end year ^a	Total deaths in thousands	Average population during war in million ^b	CSR in (per-cent)
Afghanistan	1979	2001	2,000 ⁶⁹	20	10
Angola	1980	2000	1,100	11	10
Bosnia Herzegovina	1991	1996	105 ⁷⁰	4	3
Iraq	2003	2004	162	30	1
Mozambique	1981	1988	900	13	7
Rwanda	1990	1995	1,000	6	16
Sierra Leone	1991	2000	50	5	1
Sudan	1983	2000	2,100	22	10

Source: a) Leitenberg, (2006), b) World Bank WBDI, (2013).

⁶⁵ Leitenberg (2006), pp. 73-79.

⁶⁶ Atomic Archive. <http://www.atomicarchive.com/History/coldwar/page22.shtml>.

⁶⁷ The major war in Iraq lasted one year (2003-2004) but high insurgency continued for longer than five years. The cumulative number of registered casualties in Iraq from 2003-2011 is estimated to be about 130 thousand. Iraq Body Count (2013), <http://www.iraqbodycount.org/database/>.

⁶⁸ Somalia was not added to the peer group because of the lack of data.

⁶⁹ Afghanistan is still not in peace, the total death toll from 2001-2013 is estimated to be around 30 thousand, the number of 2 million is still an appropriate estimation. See UNAMA. (2013), pp. 2-3.

⁷⁰ Zwierzchowski and Tabeau (2010), p. 17.

3.2.1 Hypothesis and Data

The following six hypotheses will be tested in the regression analysis table (6), the data sources for each of the hypotheses is given along the description of the hypothesis.

Hypothesis 1): Countries with high CSR have received more ODA.

Severe war sabotages the economy and infrastructure, causes substantial casualties, disabilities and leaves other heavy suffering on inhabitants of the country. All these factors induce an emergency of humanitarian and development aid. The data for total deaths during the war period is derived from the database of Leitenberg, the data about average population and ODA received per capita is derived from World Bank. For each of the countries in the peer group, CSR ratio is coded as a binary variable taking value (0) if CSR was below the average value of 7 percent.

Hypothesis 2): SCACs with lower level of GNI⁷¹ per capita have received more ODA.

GNI has significant positive correlation with other development indicators, its correlation with life expectancy is 0.67, with adult literacy is 0.54 and with Human Development Index (HDI) is 0.65.⁷² It can be assumed that SCACs with lower level of GNI will receive more ODA to converge to the humanitarian and constructive objectives. The data on GNI per capita is taken from World Bank Development Indicators (WBDI).

Hypothesis 3): SCACs with higher ratio of Trade/GDP have received more ODA.

Higher trade indicates openness of the economy; hence about 75 percent ODA is bilateral which also includes the commercial interests of donors. Thus it can be expected that donors prefer more open economies. The data on the variable Trade/GDP is taken from WBDI.

Hypothesis 4): SCACs with high population have received less ODA (in per capita terms).

The higher the population of a country, *Ceteris Paribus*, the lower the ODA per capita. The data on the variable is taken from WBDI.

Hypothesis 5): SCACs have received more ODA in the years post 2000 (new millennium).

The flow of aid to fragile states in the years post 2000, has increased 50 percent, thus higher ODA flow to recipient countries is expected. The variable post 2000 is a dummy variable and coded (1) for the years in new millennium.

Hypothesis 6): Countries with the deployment of NATO have received more ODA.

Since most of the NATO members are the main donors of ODA, the deployment of their forces represents their own interests and ensures their commitment; as a result higher amount of ODA is expected. The variable is coded as dummy variable (1) for NATO and (0) for UN. The data on the variables is taken from NATO⁷³ and UN⁷⁴ websites.

71 The GNI per capita is actually GNI per capita Purchasing Price Parity (PPP). GNI PPP give a better comparison basis between countries.

72 McGillivray (1991), p. 1465.

73 UN (2013), <http://www.un.org/en/peacekeeping/operations/current.shtml>.

74 NATO (2013), http://www.nato.int/cps/en/natolive/topics_52060.htm.

The dependent variable is ODA per capita. For each country in the peer group the metric data consists of eight years beginning after the end of conflict. For example the data for Afghanistan is for the years 2002-2009. The period of eight years was chosen because of two reasons 1) the major conflict in Iraq ended in 2003; 2) the latest data available was for the year 2011, so the period of eight years (2004-2011) was chosen.

$$ODA_{percapita} = \beta_0 + \beta_1 CSR + \beta_2 GNI_{percapita} + \beta_3 Trade / GDP + \beta_4 Population + \beta_5 Post2000 + \beta_6 NATO + \varepsilon \quad (1)$$

Tab. 6: Regression Output, Dependent Variable ODA per Capita

Variable	Coefficient	Std. Error	t-Statistic	Prob.	Tolerance	Variance Inflation Factor (VIF)
C	119.07	7.44	16.01	0.00		
CSR	-65.92	10.22	-6.45	0.00		
Trade/GDP	-1.93	7.49	-0.26	0.80	0.62	1.59
GNI	0.01	0.00	1.95	0.06	0.59	1.71
Post2000	-47.80	8.35	-5.73	0.00		
Population	0.00	0.00	1.25	0.22	0.46	2.17
NATO	84.66	9.96	8.50	0.00		
R ²	0.79		Durbin-Watson			1.84
Adjusted R ²	0.77		Jarque-Bera (p-value)			0.11
F-statistic	35.79		Breusch-Pagan-Godfrey (p-value)			0.06

Source: Author's Calculation, N⁷⁵ = 64.

Tolerance and VIF measure multicollinearity, critical values of tolerance are below (0.1) and critical values of VIF are above (5).⁷⁶

CSR has the highest significant negative coefficient, which indicates that on average countries with higher CSR have received about 66\$ less ODA per capita, although the severity of conflict is proportional to the humanitarian and physical destruction. The sign of the coefficient confirms the findings of Kang and Meernik; countries with higher levels of violence do not receive more ODA per capita. It may be because of two reasons that countries with high CSR have received less ODA. First, the environment in SCACs may not be secure enough so that development organizations can operate with their full scope, second CSR may not be influential parameter for donors. As 75 percent of ODA is allocat-

⁷⁵ N indicates the number of observations.

⁷⁶ University of Arizona (2013). http://www.ltrr.arizona.edu/~dmeko/notes_11.pdf and University of California Santa Cruz (y.n.g) <http://bio.classes.ucsc.edu/bio286/MicksBookPDFs/QKo6.PDF>.

ed according to the interests of donors, which also includes commercial interests, countries with high CSR may not have the infrastructure, institutional and human capacity necessary to attract investment of donors. Further research is required to study the high variation in allocation of ODA.

The coefficient of GNI is significant at a 10 percent level. This confirms the results of Alesina and Dollar, and Maizels and Nissanke. A plausible explanation can be derived by mutual consideration of CSR and GNI together. The argument for the negative coefficient of CSR was a lack of the appropriate business environment (lack of infrastructure and etc.) here the opposite is true; donors favor countries with adequate infrastructure and higher level of economic development.

The variable Trade to GDP has no influence on the allocation of ODA. A plausible explanation can be derived with mutual consideration of CSR. Due to the lack of an appropriate business environment donors do not invest in SCACs, which leads to no significant relationship between their trade and the allocation of ODA.

On average SCACs have not profited from the high flows of aid in the new millennium to fragile states. The coefficient of the variable is even negative, on average SCACs have received less ODA per capita in the post 2,000 years.

Population has no significant influence on ODA per capita allocation. The non-significant influence is confirmed with the results of Alesina and Dollar, and Maizels and Nissanke. The reason that ODA per capita is independent of population can be that on average a minimum of per capita assistance is allocated to SCACs, it is also highly probable that the costs of humanitarian and development aid in considered SCACs do not vary much.

On average SCACs have received about 48\$ less per capita aid, the coefficient is negative because the level of ODA per capita to some of the SCACs declined after the year 2000. Not all of the considered countries have profited from the recent trends in ODA.

The estimated coefficient of the variable NATO is the highest positive coefficient. Countries where NATO forces were deployed have received on averaged about 85\$ more per capita ODA than the countries where UN troops were deployed. The finding is confirmed with Kang and Meernik, countries with OECD Military involvement get more OECD aid. There are several possible reasons for the above fact; most of the members of NATO are HICs with higher financial resources, they can afford higher aid per capita to PCCs where their troops are deployed. Military involvement of NATO may attract higher media coverage and thus more public participation, which will coerce the politicians to take all possible measures to avoid personal losses (military and aid personal). For the accomplishment of the mentioned purpose they may donate more aid to promote employment and development in order to counteract insurgencies and stabilize the country. It can be that NATO countries have a joint foreign policy, with equal burden sharing when it comes to international military interventions.

3.2.2 Implication for Afghanistan and other SCACs

High CSR and low level of economic development (low GNI) are not the determinants of ODA to SCACs. Afghanistan and other SCACs should not build expectations based on

above factors to predict the allocation of aid. Neither shall all SCACs expect higher ODA in new millennium. ODA to SCACs is dependent on political decisions instead of on defined development goals. SCACs should rather try to improve their business environment (infrastructure, human and institution capacity) which will attract investment from donors and increase GNI, which will positively influence ODA.

From the result, it can be predicted the flow of aid to Afghanistan will decrease with the withdrawal of foreign troops; however, the allocation of aid will be highly dependent on political decisions. The model prediction is in line with the ground facts. The number of foreign troops in the year 2012 decreased about 29 percent from 130,638 in the year 2011 to 102,230 in the year 2012.⁷⁷ Correspondingly the amount of ODA pledges for the years 2012-2016 have decreased about 42 percent. The average value of ODA in the year 2010 and 2011 was 7\$ billion, the pledges of annual aid for the years 2012-2016 have declined to 4\$ billion.⁷⁸ The total aid (ODA and security aid) disbursed in the year 2010 and 2011 was 11\$ and 13\$ billion respectively,⁷⁹ the annual total aid pledged for the years 2012-2016 is 8\$ billion. Compared to average figure of the year 2010 and 2011 (12 billion) the total pledges of aid have decreased about 33 percent.⁸⁰

Hence the NATO variable in the above regression (table 6) is not a metric variable a conclusion about the number of troops in relation to amount of aid cannot be made; however it reveals that large amount of aid will be dependent upon political decisions and commitments of NATO member countries.

3.3 Post-Taliban Aid to Afghanistan (2002-2011)

The total commitments of FA to Afghanistan have the following structure. ODA amounts to 42 billion (46 percent) of the total commitment and Security spending to 54 percent.⁸¹ ODA is provided in bilateral and multilateral form; whereas security aid is solely bilateral. FA is being spent off-budget and on-budget. Out of total aid disbursed (2002-2011) 18 percent was on-budget and the rest was off-budget. On-budget funds for developmental and security purposes are channeled through Trust Funds. Large multilateral funds include the Afghanistan Reconstruction Trust Fund and Law and Order Trust Fund. Afghanistan Reconstruction Fund supports the reconstruction funding, by having 67 percent of share in total trust funds.⁸² Law and Order Trust Funds serves as security aid and has 30 percent of share in total trust funds. Afghanistan Reconstruction Fund was established in the 2002 in the Tokyo Conference. It is administered on behalf of 27 donors

77 Livingston and O'Hanlon (2011-2012), p. 5.

78 OECD. Statistics (2013) and CBC News (2013) http://www.cbcnews.com/8301-250_162-57436088/afghan-army-funding-a-key-concern-at-chicago-nato-summit-focus-on-2014-troop-pullout/.

79 Ministry of Finance (2012), p.10.

80 Ibid. p. 2.

81 The amount of total disbursements and commitments are taken from Ministry of Finance (2012), pp. 48-49, the figures for ODA are taken from OECD. The security aid is calculated as total aid minus ODA.

82 Ministry of Finance (2010 and 2012), pp.13 and 19.

and is managed under the supervision of a management committee comprising of the World Bank, IMF, Asian Development Bank, Islamic Development Bank and United Nations Development Program.⁸³ Government does not decide upon the fund flow into the fund.

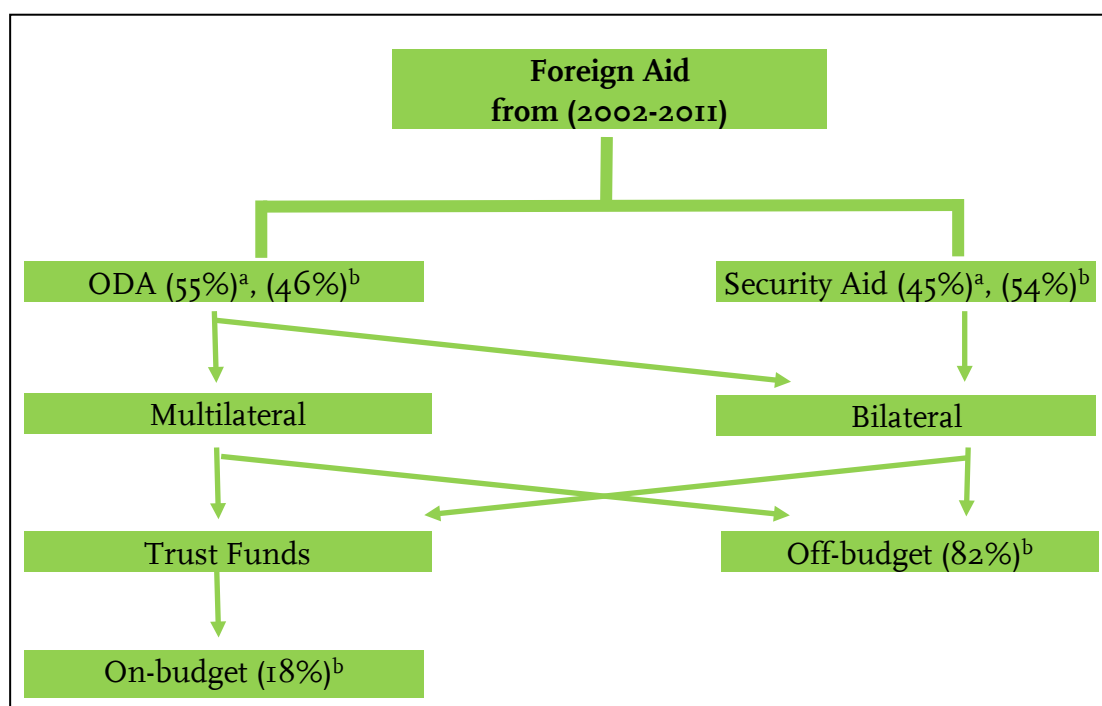


Fig. 4: Structure of the Foreign Aid to Afghanistan
 a) as % of total FA committed, b) as % of total FA disbursed
 Sources: Ministry of Finance, (2012) and OECD Statistics, (2013).

The FA spent on Afghanistan is not equal to spent `in Afghanistan`. The amount of aid spent in Afghanistan is only about 25 percent (17.2 billion) of the total aid spent on Afghanistan (70 billion).⁸⁴ Many factors contribute to the low spending ratio such as: low domestic production,⁸⁵ insecurity, corruption, lack of absorption capacity, preference of some of the donors for their national firms⁸⁶, underdevelopment of the private sector, and lack of coordination among donors and the government.⁸⁷ The problems of absorption capacity and coordination, the problem of insecurity and corruption are addressed in

83 Panda, (2011), p. 6.

84 See table (3).

85 See table (10), for trade account balance.

86 US share in total aid disbursed on Afghanistan is about 70 percent. Ministry of Finance (2012). pp. 48-49. In the years 2007 and 2009, half of reconstruction funds of US were provided by its bilateral agency USAID. Most of them were allocated to two firms based in Maryland. Crisis Group (2011), p. 19.

87 Peace Divided Trust (2009), pp. 21-26.

section (4.2.3). In the following sections the total amount of aid (ODA and security), spent on and in Afghanistan are described.

3.3.1 Official Development Assistance Spent on Afghanistan

ODA amounts to 46\$ billion (55 percent) and 32\$ billion (46 percent) of the total assistance committed and disbursed respectively. ODA is provided in multilateral and bilateral form from 2001 to 2011 multilateral and bilateral ODA accounted for about 81 and 19 percent of ODA disbursements respectively. As the figure (5) shows, the total ODA pledges have a non-uniform growth, except the year 2011.

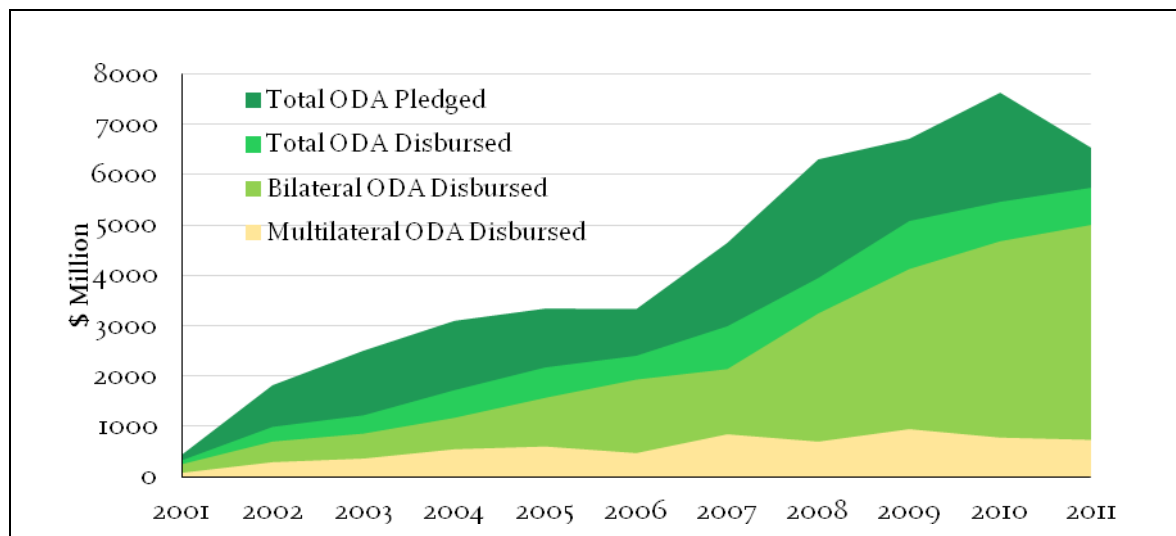


Fig. 5: ODA to Afghanistan
Source: OECD Statistics, (2013).

In the first five years, the annual amount of ODA disbursed was less than 2.5\$ billion. The rapid increase in the year 2007 was due to the London Conference (January, 2006) in which pledges of 8.7\$ billion were made. The focus of the conference was the Afghan Compact.⁸⁸ The decrease in ODA (14 percent) in the year 2011 marked the beginning of withdrawal process; however the disbursement continued its increasing trend in the year 2011. The Dispersion Ratio (DR) i.e. overall share of ODA disbursed to ODA committed in the given period is 70 percent. In the first three years the DR was only 53 percent of the ODA committed. The share of multilateral ODA from 2001-2006 was 37 percent; however, from 2007-2011 the share declined to 23 percent. A reason for the decline seems to be that bilateral and multilateral donors channel some of their funds through trust funds to

⁸⁸ In London Conference the government of Afghanistan presented the strategic framework for development called the Afghan Compact. The pillars of the compact were Security, Governance and Economic Development. See: http://www.nato.int/isaf/docu/epub/pdf/afghanistan_compact.pdf.

Afghanistan. The average share of trust funds to disbursed ODA from 2002-2011 is 24 percent; however, trust funds are not solely under the discretion of the government.⁸⁹

Because of the fact that the involvement of the international community in Afghanistan is mainly due to security concerns it is worth to see if there is a relationship between ODA commitments and security incidences. The correlation of ODA commitment with ISAF fatalities from 2001-2011 is 0.93.⁹⁰ The correlation of average US troops on the ground and ODA commitment for the year 2002-2008 and 2002-2011 is 0.93 and 0.95 respectively.⁹¹ In the year 2005 as security deteriorated and the number of ISAF fatalities increased to 118 percent—the high insurgency in 2005 is also captured by terrorism index—the ODA pledges in the London Conference also increased rapidly; nevertheless, security was a core topic in London Conference. The same trend applies to the year 2011, the ISAF fatalities decreased for the first time since 2003 which was accompanied by a simultaneous first time decrease in ODA pledges. After 2006 with an increase in insurgency NATO tried to apply a more integrated strategy involving preemptive combat, and increased development work.⁹² It seems that the security situation does have an influence on the ODA commitments, as donors try to stabilize the situation with an increase in development assistance.

A Comparison of ODA per Capita Commitments with Bosnia and Iraq

From the results of section (3.2) it is appropriate to compare the ODA per capita provided to Afghanistan to PCCs with NATO military intervention.⁹³ ODA per capita to Afghanistan shows an unusual pattern compared to Bosnia and Iraq; both of the mentioned countries received higher ODA per capita in the first three Post Conflict years (PCYs) compared to 4-8 PCYs; however, the opposite is true for Afghanistan. The overall ODA per capita in the eight PCYs to Afghanistan was only 60 and 43 percent of Bosnia Herzegovina and Iraq respectively. The amount of aid spent per capita on Afghanistan during the early years was the lowest amount spent in any recent conflict zone.⁹⁴ For a better comparison the two significant coefficients of the regression from section (3.2) namely GNI per capita and CSR can be considered. Afghanistan's GNI was only 15 and 24 Percent of Bosnia Herzegovina and Iraq respectively, and its CSR was 3.4 and 20 times higher respectively, but still the commitments of ODA per capita in the considered years were less than the mentioned countries. Though the ODA increased in later years the initial low values indicate an inadequate Post Conflict Economic Reconstruction (PCER) plan. Resources pledged were not sufficient for the task of reconstruction, the insufficiency of resources hindered development.

89 Ministry of Finance (2011), p. 18 compare with OECD Statistics (2013).

90 The correlation is calculated. The casualties figures are taken from <http://icasualties.org/oef/> and ODA from OECD Statistics (2013).

91 The average number of troops per year (2009-2001) is based on the estimation of the source. Belasco (2009), p. 9.

92 Katzman (2009), p. 26.

93 The ODA figures for Iraq are available only for eight years, because of the reason eight years are considered.

94 Carter (2013), p. 1.

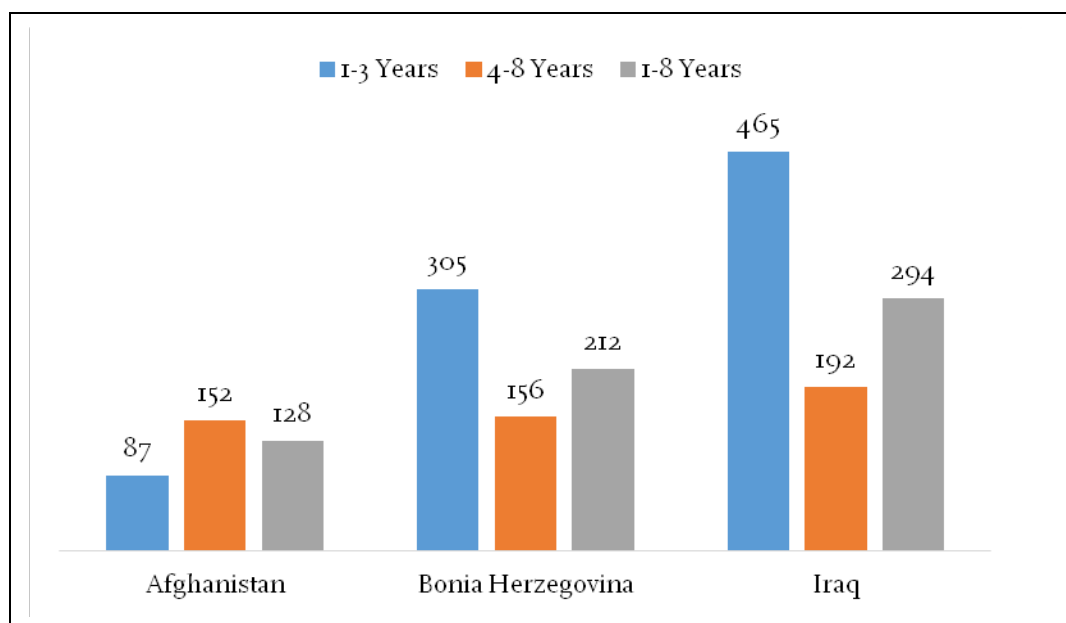


Fig. 6: A Comparison of ODA per Capita Commitments with Bosnia and Iraq
Source: World Bank WBDI, (2013) and OECD Statistics, (2013).

The Sectoral Allocation of ODA

The largest ODA recipient sector is social infrastructure & services, followed by economic infrastructure & services sector. As shown in the figure (7), in the first three years the disbursements were very low and due to high return of refugee and severe humanitarian conditions, the focus was mainly on humanitarian aid rather than on economy and infrastructure, making the PCER extremely difficult.

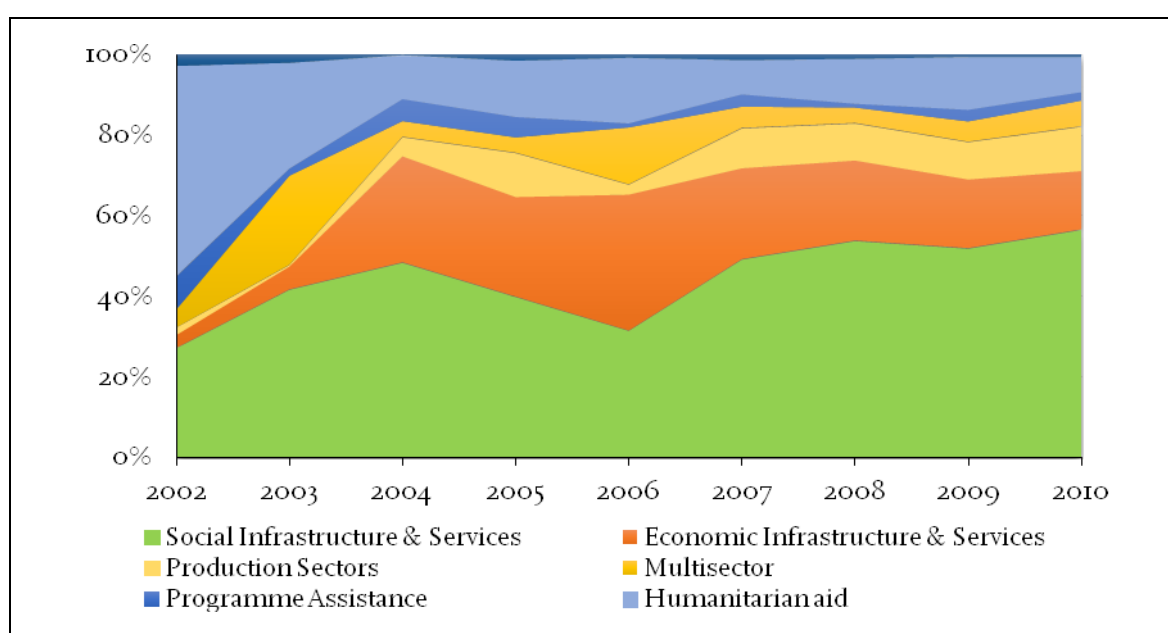


Fig. 7: Sectoral Allocation of Bilateral ODA
Source: OECD, Statistics, (2013).

3.3.2 Security Aid Spent on Afghanistan

Security aid is spent on armed forces (military and police). It accounts to 39\$ billion (46 percent) and 38\$ billion (54 percent) of the total assistance commitments and disbursements respectively. On-budget security aid accounts to 2.88⁹⁵ billion (4 percent) of total foreign assistance disbursements and 22 percent of total on-budget aid disbursements. The bulk of the aid was provided by the US (95 percent) in the year 2011, followed by Japan (3 percent) and other donors.⁹⁶ The annual figures of total security aid committed and disbursed by all donors are not available. An approximation can be done by adjusting the annual US security aid pledges which amount to 41\$ billion⁹⁷ as of December of 2011, and then multiply by the factor (0.93) to get the cumulative disbursement of 38\$ billion for the year 2002-2011 Figure (8) shows the total approximated disbursement from 2002-2011.

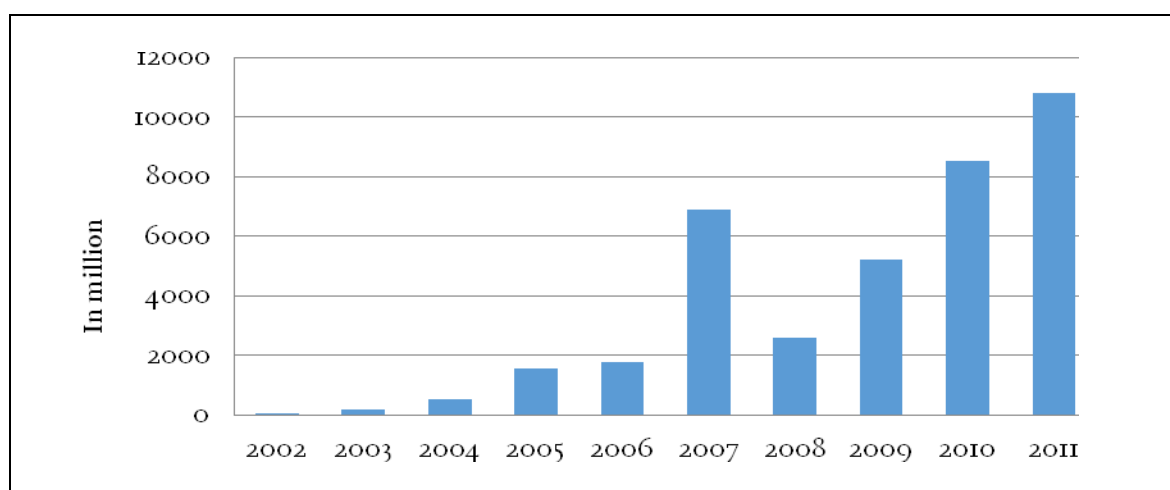


Fig. 8: Approximated Security Aid Disbursements in Million
Source: Sigar, (2012).

In the first three years the security aid was very low, leading to the deterioration of security. More than 50 percent of security aid was disbursed in the years 2010-2011 and the reason was 30,000 new US troops to target insurgency.⁹⁸

Sectoral Disbursement of Security Aid

The sectoral allocation of security aid is available only for US aid. Out of 31 billion of US security aid disbursed, 40 percent has gone to equipment and transportation of Afghan security forces, followed by sustainment, infrastructure and training and operations.

⁹⁵ Ministry of Finance (2010-11), p. 30 and p. 17.

⁹⁶ Ministry of Finance (2011), p. 14.

⁹⁷ SIGAR (2012), p. 170.

⁹⁸ New York Time (2013), see: http://www.nytimes.com/2009/12/01/world/asia/o1orders.html?_r=0.

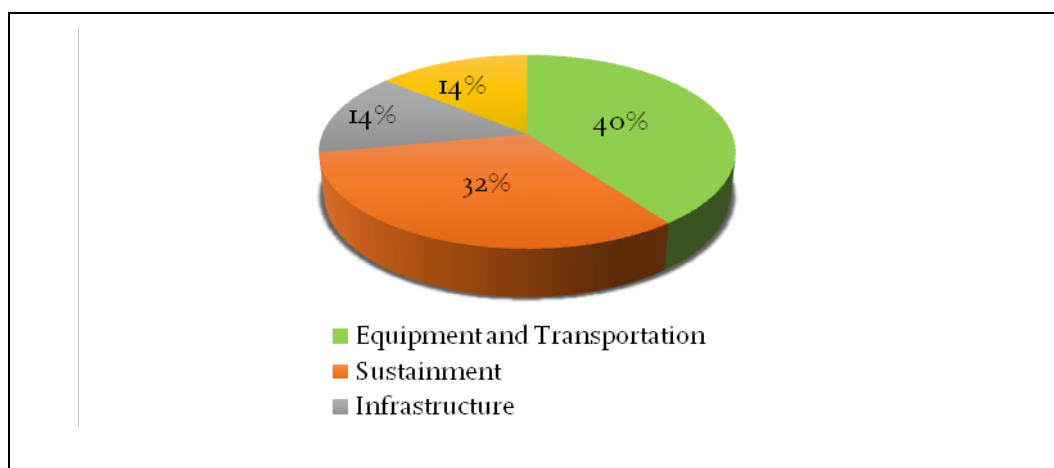


Fig. 9: Sectoral Allocation of Security Aid
Source: Sigar, (2012).

3.4 Foreign Aid Spent on and in Afghanistan

The FA spent in Afghanistan is far less than what is spent on Afghanistan. The impact of spending is dependent on a) the form of aid (ODA or security aid) and b) the channel of spending off-budget or on-budget. According to Peace Dividend Trust, the average Domestic Spending Ratio (DSR) of ODA in the years 2005 and 2006 was 34 percent i.e. only 34 cents out of each dollar of ODA entered afghan economy. The local economic impact of ODA is dramatically higher when aid is channeled through trust funds or directly to the government with DSR of 80 percent relative to funds provided to international companies or organizations with DSR of 15 percent.⁹⁹ According to World Bank as shown in table (7) the DSR of the off-budget ODA and security aid is only 10-25 and 17-25 percent respectively.¹⁰⁰ As only 18 percent of total foreign assistance (security 4 and ODA 14)¹⁰¹ is spent on-budget, tables (8 and 9) show the amount of money spent on and in Afghanistan; the calculations are based on average value of table (7). The DSR of total off-budget aid according to above estimation is only 16 percent (9.1 divided by 57.4), which means that only 16 cents of each dollar off-budget aid have been spent in Afghanistan.

Tab. 7: Domestic Spending Ratio of On-budget and Off-budget ODA and Security Aid

Foreign Aid	On-budget	Off-budget
ODA	55-60	17-25
Security aid	90-95	10-25

Sources: World Bank, (2013).

⁹⁹ Peace Dividend Trust (2009), p. 1.

¹⁰⁰ World Bank (2013), p. 55.

¹⁰¹ Ministry of Finance (2012 & 2010), pp. 17 and 30.

Tab. 8: Domestic Spending Ratio of Off-budget ODA and Security Aid

Foreign Aid	Total aid disbursed in \$ billion	Total aid - disbursed off-budget \$ billion	Off-budget DSR in %	Average DSR in %	Off-budget aid spent domestically \$ billion
ODA	32	22.3	17-25	21	4.7
Security Aid	38	35.1	10-15	12.5	4.4
Sum	70	57.4			9.1

Source: Author's Calculations Compiled from World Bank, (2013) and Ministry of Finance, (2012).

Tab. 9: Domestic Spending Ratio of On-budget ODA and Security Aid

Foreign Assistance	Total aid disbursed in \$ billion	Total aid disbursed on-budget \$ billion	On-budget DSR in %	Average DSR in %	On-budget aid spent domestically in \$ billion
ODA	32	9.7	55-60	57.5	5.6
Security Aid	38	2.8	90-95	92.5	2.6
Sum	70	12.5			8.2

Source: Author's Calculations Compiled from World Bank, (2013) and Ministry of Finance, (2012).

The DSR of total on-budget aid according to the above estimation is only 66 percent (8.2 divided by 12.5 * 100), which means that only 66 cents of each dollar on-budget aid are spend in Afghanistan. The DSR of on-budget aid is about 4 times higher than off-budget aid.

Tab. 10: Total Spending Ratio of ODA and Security Aid

Foreign Assistance	Total aid disbursed in \$ billion	Total on-budget aid disbursed domestically \$ billion	Total off-budget aid disbursed domestically in \$ billion	Total aid disbursed domestically in \$ billion	On-budget aid spent domestically \$ billion
Security Aid	38	2.6	4.4	7.0	0.18
ODA	32	5.6	4.7	10.3	0.32
Sum	70	8.2	9.1	17.2	0.25

Source: Author's Calculations Compiled from World Bank, (2013) and Ministry of Finance, (2012).

The DSR of total ODA and security aid is 18 and 32 percent respectively. The total DSR is 25 percent. Out of 70 \$ billion spent on Afghanistan, only 17.2 \$ billion were spent domestically.

4 THE ECONOMIC SHOCK TO AFGHANISTAN

4.1 The Shock to Economic Growth

To analyze the shock to economic growth caused by the reduction in ODA and security aid, the neo classical growth model of Solow-Swan in per capita terms is applied.

$$gPCI = gA + a \left(\frac{s + kim}{k} - n \right) = gA + a \left(\frac{s + fdi + aid + debt}{k} - n \right) \quad (2)$$

$gPCI$ = real growth rate of Per Capita Income (PCI)

gA = growth rate to technological advancement/progress (total factor productivity)

a = partial production elasticity of capital

s = saving rate as percentage of GDP

kim = capital import in an economy, which consists of (fdi, aid and debt)

fdi = foreign Direct Investment as percentage of GDP

aid = international aid (Security and Development) as percentage of GDP

$debt$ = government debt as percentage of GDP

k = capital coefficient

n = growth rate of population

The model analysis the real GDP per capita income growth rate as function of the growth rate of technological advancement, savings, capital imports and the growth rate of labor. According to the model an increase in (gA , s and kim) increases the per capita income, whereas an increase in population growth rate (n) and a higher capital coefficient (k) negatively affect per capita income growth rate.

4.1.1 Regression Results Based on Solow Model

Based on equation (2), prior to estimation of real¹⁰² GDP per capita growth of Afghanistan, in a pre-test of data analysis it was found that FDI had a high correlation (above 0.82) with the variable saving and was not explaining the variance in dependent variable. Because of the mentioned reasons the variable was removed from the regression. The link between FDI and other variables is described in section (4.1.3). In the pre-test of data analysis linear and non-linear forms of all variable were tested, none of the variables in non-linear form could explain significantly higher variance of the dependent variable than their linear forms. To ensure that the results are not distorted/biased by multicollinearity the non-linear form of the variables were excluded from the estimation.

In order to get the true effect of ODA and security aid on GDP per capita growth individually, they are estimated in two separate regression table (11 and 12), so that they are not effected by their mutual correlation of (0.5). The base year for table (11) is 2003, savings are presented by Gross Capital Formation (GCF). The data source of ODA is OECD geo-

¹⁰² The data was converted to real GDP using deflator index (base year 2002). The estimated period covers nine years (2003-2011).

graphical disbursement (2008, 2013), the data source of other variables is World Bank WBDI (2013).

Tab. 11: Regression Output Dependent Variable: GDP per Capita Growth, N = 9

Variable	Coefficient	Std. Error	t-Statistic	Prob.	Tolerance	VIF
C	-2.23	1.54	-1.45	0.21		
GCF/GDP	-0.47	0.33	-1.4	0.22	0.44	2.28
(Security aid)/GDP	0.28	0.11	2.45	0.06	0.93	1.07
Population Growth	84.29	56.51	1.49	0.20	0.45	2.2
R ²	0.67	Breusch-Pagan-Godfrey (p- value)				0.84
Adjusted R ²	0.48	Jarque-Bera (p-value)				0.32
F-Test (p-value)	0.11					

Source: Author's estimation.

Tab. 12: Regression Output Dependent Variable: GDP per Capita Growth, N = 9

Variable	Coefficient	Std. Error	t-Statistic	Prob.	Tolerance	VIF
C	-0.98	1.26	-0.78	0.47		
GCF/GDP	-0.76	0.3	-2.55	0.05	0.44	2.26
ODA/GDP	0.66	0.22	2.97	0.03	0.63	1.59
Population Growth	36.61	47.04	0.78	0.47	0.4	2.53
R ²	0.74	Breusch-Pagan-Godfrey (p- value)				0.92
Adjusted R ²	0.59	Jarque-Bera (p-value)				0.52
F-Test (p-value)	0.06					

Source: Author's estimation.

The results are in line with Collier and Hoeffler, in PCCs aid does significantly contributes to economic growth. The coefficient of security aid on GDP per capita growth is 0.28 in table (11) compared to 0.66 of ODA in table (12). Ceteris Paribus a one unit reduction of ODA to GDP will decrease GDP per capita growth about 0.66 units. Reduction in ODA will have 2.36 times higher negative impact on GDP per capita growth than security aid.

The high difference between the coefficient of ODA and security aid is probably because of two reasons. First, the DSR of security aid is 18 compared to 32 of OD.¹⁰³ Second, security aid is allocated in sectors and purposes that do not necessarily contribute to economic growth such as operation and training purposes. Only 14 percent of security aid goes to construction, which has direct effects on growth via investment. However, the results must be cautiously interpreted because the figures of security aid figures are approximated. ODA has relatively higher DSR and has significantly contributed to economic growth. For the first time in history, more than 4,000 kilometers of paved highways and tertiary roads have been built in the country. Electricity access to 30 percent of people has been enabled because of aid financed projects.¹⁰⁴ From 2002-2008 around 3,500 school buildings were constructed or rehabilitated.¹⁰⁵

The coefficient of GCF is negative in table (11 and 12), in table (12) it is even significant. Hence, the data of second regression is more accurate than (11) —because of approximation of security aid—, it is more reliable. The interpretation of this negative coefficient of GCF is not possible without deeper knowledge of the ground facts of Afghan economy. A plausible reason is probably the high share of the illicit sector (opium and etc.), which contributes positively to GCF but negatively to GDP growth. The illicit sector is not included in the calculation/composition of GDP. The drug economy grows very well in an insecure and lawless environment, which has dramatic negative effects on economic growth. Figure (10) and table (13) provide necessary information on the drug production and their value in Afghan economy.

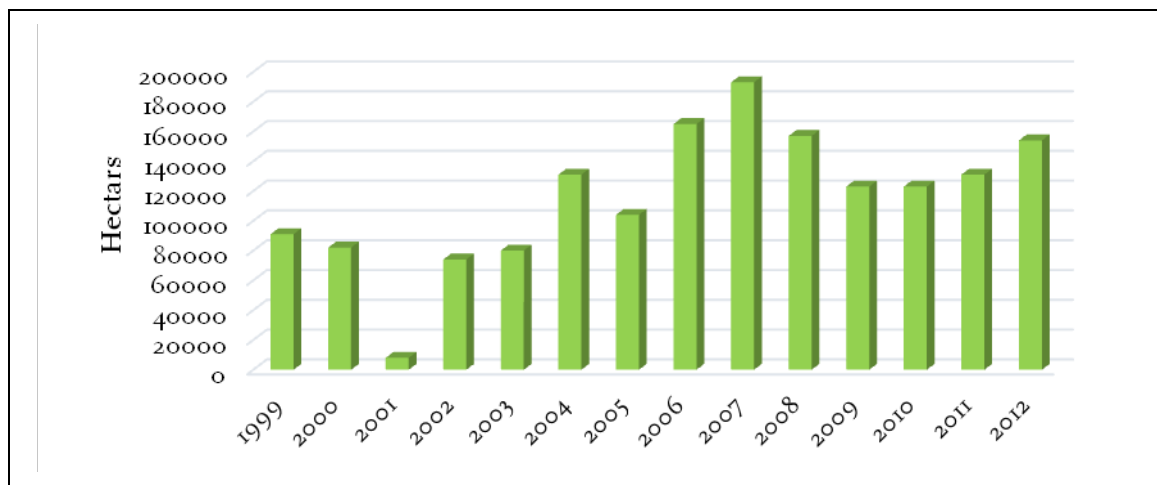


Fig. 10: Opium Cultivation from (1999-2012), Source: UNODC, (2011).

Opium became a part of the Afghan economy during the war with Soviet Union, since then it has been a major part of the economy. The decline in cultivation in the year 2001 was because of the ban of Taliban on opium cultivation in the year 2001.¹⁰⁶

¹⁰³ See section (3.4).

¹⁰⁴ Ministry of Finance (2010), p. 7.

¹⁰⁵ CWfA (2011), http://www.cw4wafghan.ca/sites/default/files/SchoolInfrastructure_o.pdf.

¹⁰⁶ Opioids (2011). <http://www.opioids.com/timeline/>.

Tab. 13: Farm Gate and Export Value of Opium to GDP

	2006	2007	2008	2009	2010	2011
Total farm-gate value of opium in % of GDP	11	12	7	4	5	9
Potential net export value of opiates in % of GDP	45	49	35 ¹⁰⁷	21	9	15

Source: UNODC, (2006-2011).

The net export value of opiates in the year 2006 and 2007 was almost half the GDP. The correlation between the ratio of net export value of opiates to GDP and GCF to GDP is 95 percent.¹⁰⁸ Figure (11) shows the share of net export value of opiates and GCF to GDP. The high share of opiates export value to GDP and its almost equivalent share as GCF supports the argument that GCF in the country is mainly driven by investments from opium. Compared with table (13) it provides significant evidence that illicit economy develops splendidly in an insecure and corrupt environment. From 2006-2011 the average share of GCF to GDP was 35 percent, in the mentioned period the share of net export value of opiates to GDP was 29 percent.

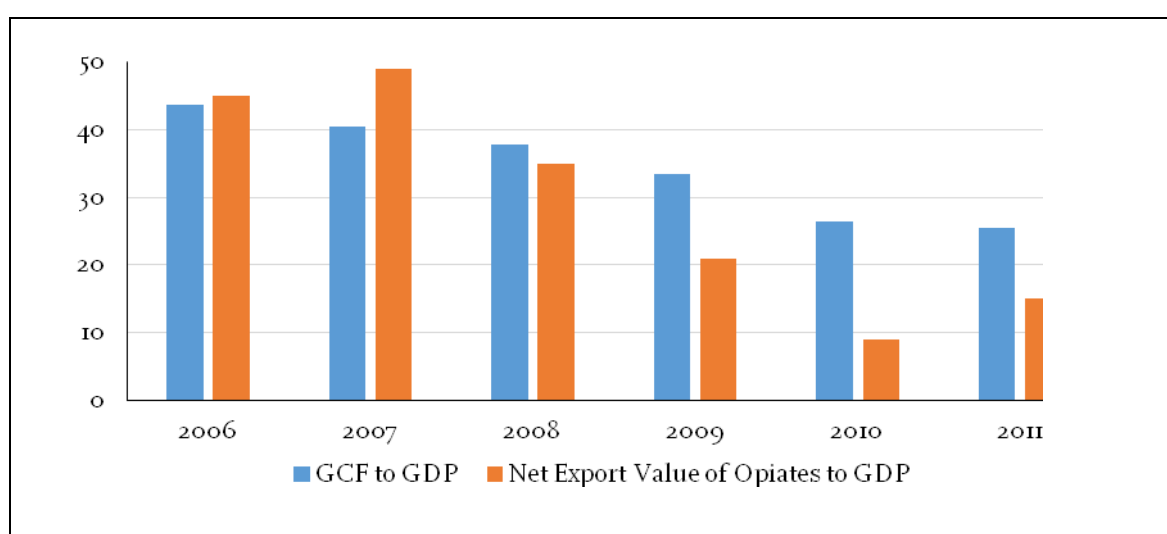


Fig. 11: Net Export Value of Opiates and GCF to GDP

Source: UNODC, (2006-2011) and World Bank WBDI, (2013).

By comparison of table (13 with 11 and 12) it seems that there is a well-developed relationship between the illicit economy, insecurity and corruption in the country, which is negatively affecting economic growth through GCF. This relationship was first described by the World Bank; which called it a 'vicious circle' illustrated in the figure (12).

¹⁰⁷ Was estimated as average value of 2007 and 2009.

¹⁰⁸ Calculated, Source: World Bank WBDI (2013) and UNDOC (2006-2011).

4.1.2 GDP Growth and Vicious Circle

The opium economy has profound adverse consequences for security, development, and state building in Afghanistan. It contributes to a vicious circle whereby the drug industry backs warlords¹⁰⁹, and their militias, who in turn weaken the government. As a result the state remains ineffective and security weak, thereby preserving an environment in which the drug industry can continue to thrive. The bonds between opium, warlords, and insecurity add up to a vicious circle of mutually-reinforcing problems. There is also some evidence of linkages between drug money and terrorist networks. Warlords, smugglers and terrorists work together to deteriorate security and weaken the state. The opium economy presents a serious threat to the effective governance, development and economic growth of the country.

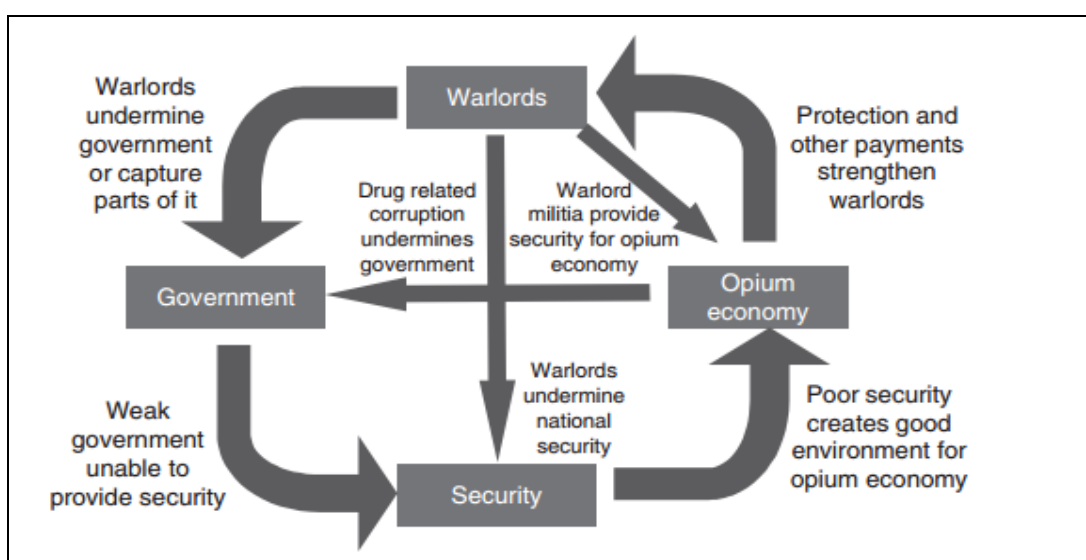


Fig. 12: The Vicious Circle in Afghanistan

Source: World Bank, (2005).

4.1.3 Emergence of the Vicious Circle and FDI

Goodhand attributes the emergence of this vicious circle to three main factors.¹¹⁰ First, the Taliban's opium ban, figure (10), increased prices and a growth in opium-related debt in rural areas. Poor farmers had little choice but to plant opium in 2001 in order to repay their debts. For more wealthy farmers, high prices created strong incentives to allocate land to poppy because of drought, as well as the law and order vacuum in opium producing provinces after 2001. Second, Warlords were brought back to power, the new transitional government had to share key ministries and tax revenue's with them¹¹¹ They were

¹⁰⁹ Warlords in Afghanistan refer to group of people, who are responsible for the civil war in 1990s after the withdrawal of Soviet forces. Most of the Warlords were overthrown by the Taliban in late 1990s. See: Sedra (2006). p. 3.

¹¹⁰ Goodhand (2008), pp. 408-409.

¹¹¹ Castillo (2009), p. 184.

paid millions of dollars to fight Taliban and to buy their support against Taliban and their affiliates. These funds were allocated as loans to farmers to cover the cost of next spring's poppy. Warlords used the money to enrich themselves, buy key positions in the government and fund lucrative criminal enterprises like narcotics trafficking, extortion, and similar illicit activities.¹¹² Third, foreign troops initially adopted a noninterventionist policy towards drugs, born out of the strong tension between counter-insurgency and counter-narcotics objectives. Their presence in the early years was limited to Kabul.

The corruption and insecurity caused by the vicious circle has had dramatic effects on licit domestic investment and FDI in the country. In a survey of 146 private business in Kabul, 86 percent of business revealed corruption and insecurity as major constrain to their business.¹¹³

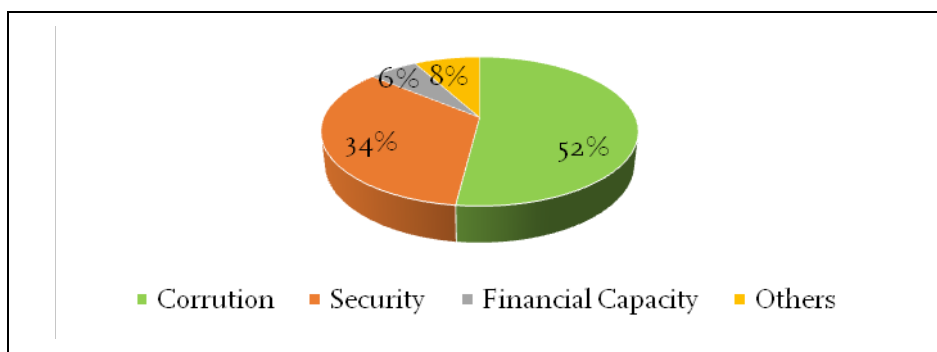


Fig. 13: Major Business Challenges
Source: Peace Dividend Trust, (2011).

Insecurity and corruption not only negatively influence licit domestic investments, but also FDI. In the relatively peaceful years of 2003-2005, the share of FDI to GDP increased more than threefold, but in later years as security and corruption got worse, the ratio of FDI to GDP also declined significantly.

¹¹² Carter (2013), p. 7.

¹¹³ Peace Dividend Trust (2011), p. 20.

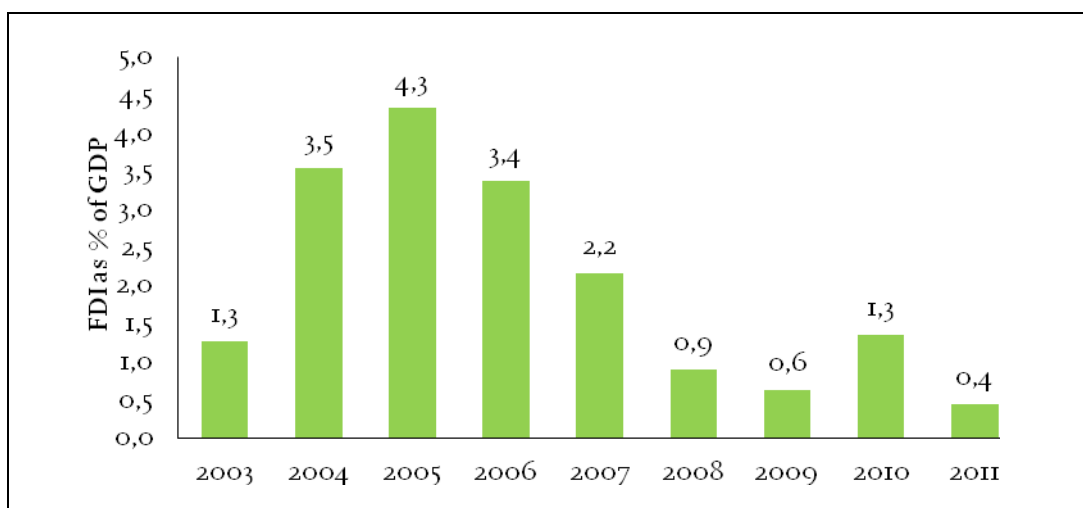


Fig. 14: FDI as a percentage of GDP
Source: World Bank, (2013).

FDI is a major driver of economic development in developing countries and PCCs, but in Afghanistan because of corruption and insecurity it started decreasing in 2006, despite the fact that overall FDI flow to south Asian countries increased.¹¹⁴ The above facts suggest possible reasons for the insignificant influence of FDI on GDP growth of the country. To know if ODA or security aid are crowding out FDI, correlations between them were estimated as given in table (14).

Tab. 14: Correlation between ODA Security Aid and FDI

	(Security aid)/GDP	FDI/GDP	ODA/GDP
(Security aid)/GDP	1	-0.33	0.5
FDI/GDP	-0.33	1	0.09
ODA/GDP	0.5	0.09	1.00

Source: Author's estimation.

The correlation between ODA and FDI is positive, suggesting that ODA is not crowding out FDI. The correlation between security aid and FDI is negative, but this does not indicate any causal effect. The reason for the negative correlation is that the annual ratio of FDI and security aid to GDP had opposite trends, which can be seen by comparing figures 8 and 14. To be certain, the ratio of security aid to GDP in the year 2004 was multiplied by 10, which led to a positive correlation of 0.13 between FDI and security aid.

¹¹⁴ Civil Military Fusion Center (2012), p. 2.

4.2 The Shock to Fiscal Budget

The core budget of the country consists of operation budget and development budget.¹¹⁵ Out of total aid disbursed (70\$ billion 2002-2011) 18 percent was on-budget and the rest was off-budget. The total revenues of the core budget come from two sources: domestic revenues and donor grants. Domestic revenues include tax revenue (fixed taxes, income taxes, property taxes, sales taxes, excise taxes, customs duties, and others) and non-tax revenue (social contributions, income from capital properties, non-tax fines and penalties, sale of goods and services, royalties and sale of assets).¹¹⁶ Domestic revenues flow in to revenues of 'operation budget'. The grants to operation budget are 100 percent discretionary (under the spending priorities of the government). The whole development budget is financed by grants. The grants to development budget are about 30% discretionary (under the spending priorities of the government) and 70% non-discretionary (under the spending priorities/authorities of the donors).¹¹⁷

4.2.1 Revenues of Core Budget

Table (15) shows the percentage of operation, development and donor grants in core budget.

Tab. 15: Core Budget (Operation, Development and Grants)

Revenue sources of core budget	2005	2006	2007	2008	2009	2010	2011
Domestic revenues	426	536	715	919	1,069	1,466	2,161
Donor grants to operation budget	348	366	481	558	723	1,074	1,481
Donor grants to development budget	570	743	1,053	1,342	940	726	688
Total operation budget	774	902	1,196	1,477	1,792	2,540	3,642
Total core budget	1,344	1,645	2,249	2,819	2,732	3,266	4,330
Operation budget as % of core budget	58	55	53	52	66	78	84
Development budget as % of operation budget	74	82	88	91	52	29	19
Domestic revenues as % of operation budget	55	59	60	62	60	58	59
Donor grants as % of core budget	68	67	68	67	61	55	50

Source: Author's Calculation, Compiled from Ministry of Finance, (2012).

¹¹⁵ Panda (2011), p. 4.

¹¹⁶ Ministry of Finance, Revenues (2011), p. 8.

¹¹⁷ Ministry of Finance, Revenues (2009), p. 75 and Ministry of Finance, Budget (2011), p. 13.

From (2005-2011) domestic revenues have significantly increased by more than a factor of 5. The rapid growth is due to the adoption of income tax laws in the year 2005, strengthening of revenue collection, expansion of the tax bases, improvement of tax compliance, enhancement of the capacity of tax administration staff and strong economic growth.¹¹⁸ Donor grants to operation budget have increased continuously since 2005, accompanied by simultaneous increase in domestic revenues; the share of the operation budget in the core budget has increased from 58% to 84% in the considered timeframe (2005-2011). The grants to the development budget have decreased since 2008; the reason is the low budget execution of the development budget. Figure (15) shows the budget execution rate of the development as well as the operation budget.

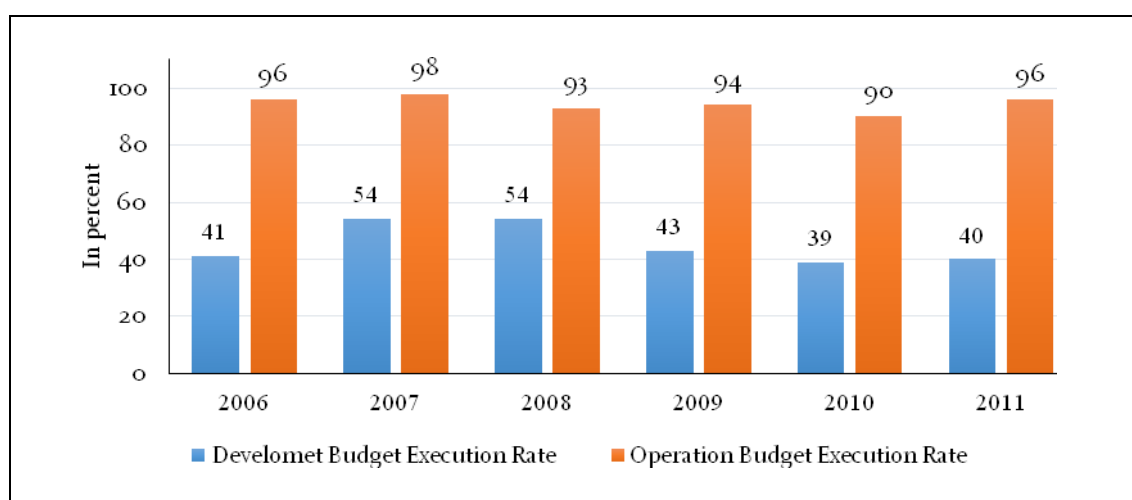


Fig. 15: Development and Operation Budget Execution Ratio
Source: World Bank, (2012).

The execution ratio of the operation budget is considerably higher than that of the development budget. A possible reason is that about 100 percent of the operation budget is discretionary, whereas only 30 percent of the development budget is discretionary. The major constraint on budget execution is the low absorption capacity of the government which is described in section 4.2.3. Though the share of donor grants to core budget has decreased from 68 percent in 2005 to 50 percent in 2011, the budget is to half dependent on grants. Domestic revenues cover only 59 percent of the operation expenditure, which are essential for the maintenance of the government's structure. Reduction in grants to the operation budget will have significant negative effects on the structure and legitimacy of the government, whereas up to 55 percent reduction in development budget will have no effects on the economy, because the government has spent on average only 45 percent of its development budget.

¹¹⁸ Ministry of Finance Budget (2011), p. 6.

4.2.2 Sectoral Allocation of Development and Operation Budget

The operation budget covers the recurring costs and is essential for the operations and maintenance of the government's structure. Operation costs cover the recurring costs of ministries, provincial offices and etc. Figure (16) shows the sectoral allocation of operational budget.

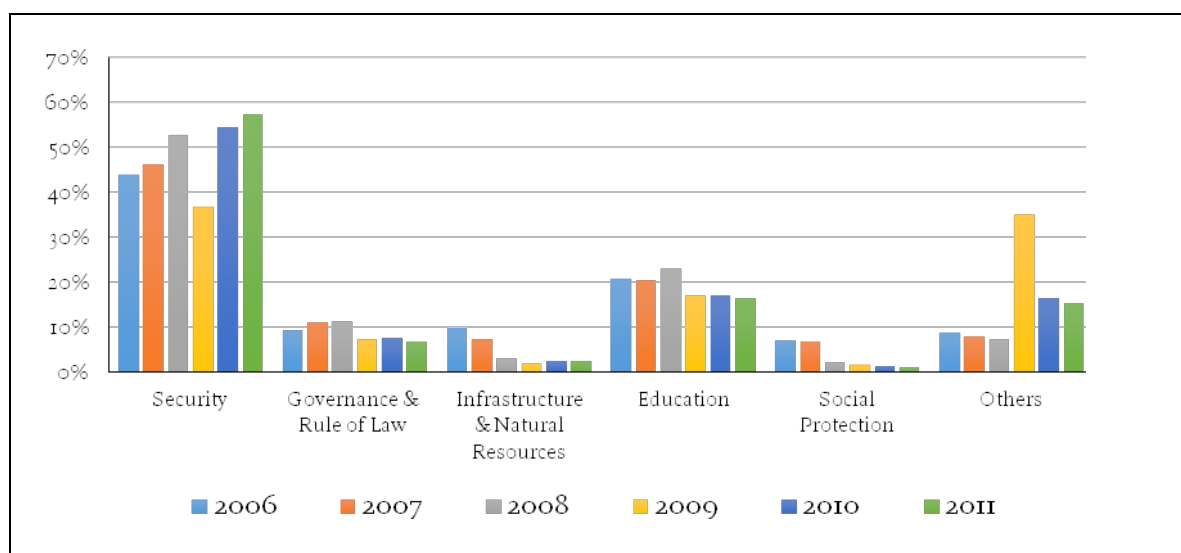


Fig. 16: Sectoral Allocation of Operation Budget
Source: Ministry of Finance, Budget, (2007, 2009).

In the year 2010/2011 above than 55 percent of operation budget was allocated to the security sector, followed by education which received about 17 percent. Reduction in grants to operation budget will have dramatic effects on the already deteriorated security of the country. The proportion of funds allocated to the education and social sectors have decreased due to an increase in security expenditure. The elements of the vicious circle (insecurity) are diverting aid resources from other essential sectors such education, social protection and infrastructure to security, which is undermining the economic growth and development of the country.

Development expenditure includes all cost of development projects executed by the government at both the district and provincial levels of the country. As figure (17) shows the development budget is mainly allocated to infrastructure and reconstruction projects, followed by agriculture and rural development. In the case of a greater than 55 percent reduction in development grants, the most affected sectors would be infrastructure, agriculture and education. Reduction in grants to operation budget would also have considerable consequences for government employees, in the year 2011 the total number of public sector employees were 740,000¹¹⁹ allocated in different sectors as shown in figure (18).

¹¹⁹ Total public sector employee cost amounted to 56 percent of core budget in the year 2011 dividing by the number of total employees (740,000) it gives monthly average salary of 273 dollars for each employee. See: Ministry of Finance, Budget (2013), p. 21.

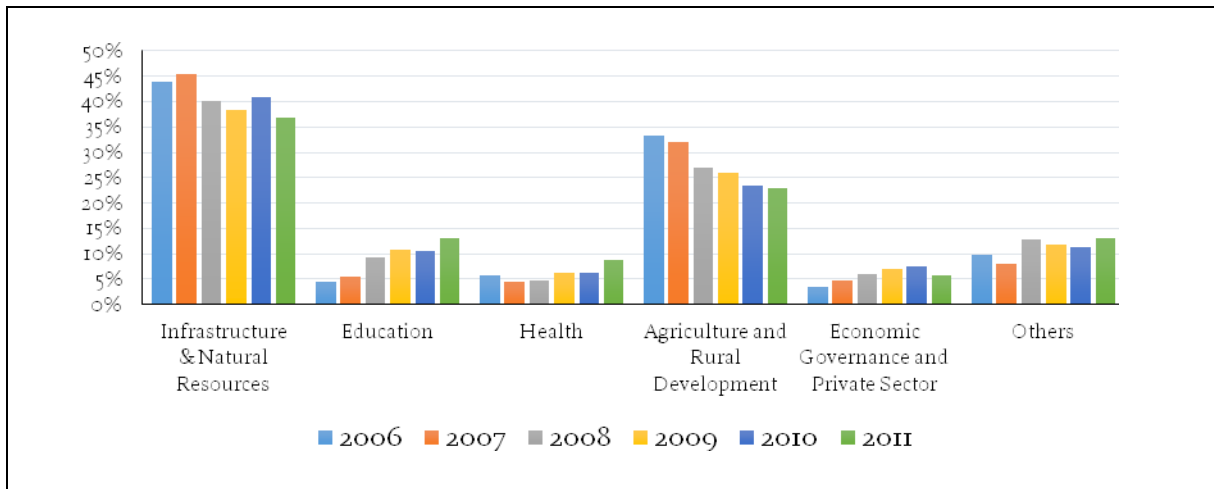


Fig. 17: Sectoral Allocation of Operation Budget
Source: Ministry of Finance, Budget, (2009, 2010).

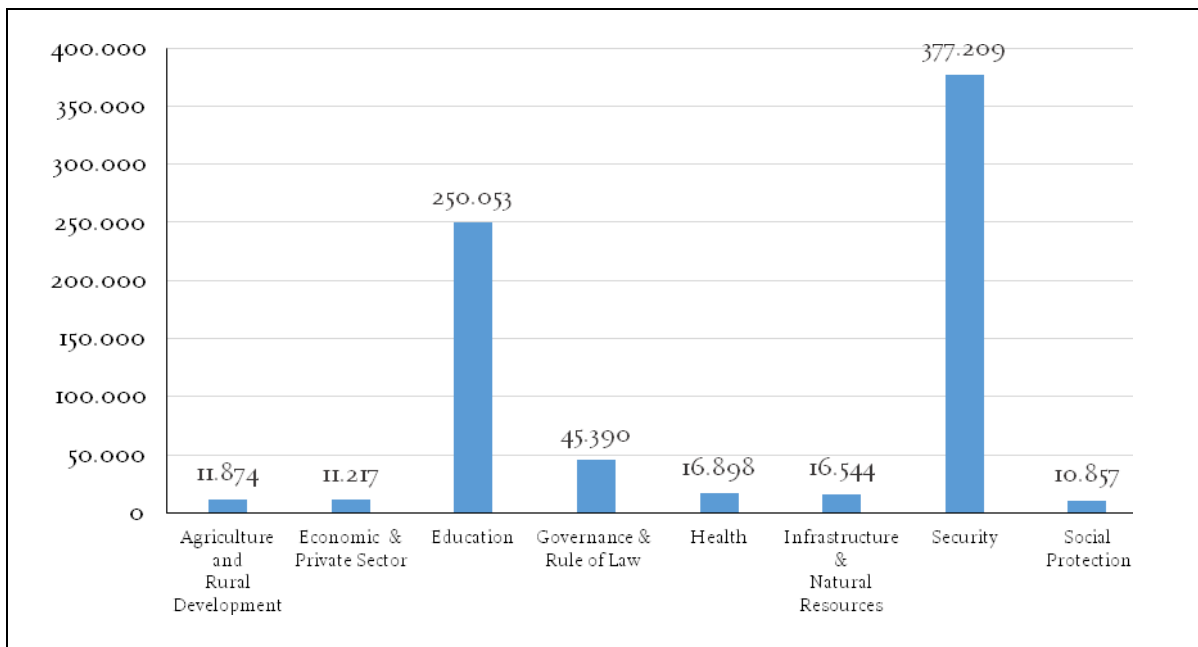


Fig. 18: Number of Public Sector Employees in Different Sectors
Source: Ministry of Finance, Budget, (2011).

Because of high insecurity most of the public sector employees are employed in the armed forces sector, followed by the education sector. Wages accounted for more than 56 percent of core budget expenditure in the year 2011, in the same year donor grants covered 50 percent of core budget expenditure.¹²⁰ Any reduction in operation grants will have severe consequences for the public sector employees, who employed—as shown in Table (16) about 6 percent of total employed labor force of the country in the year 2011.

¹²⁰ Ministry of Finance, Budget (2013), p. 21.

Tab. 16: Population, Labor Force and Employment

	2006	2007	2008	2009	2010	2011
Total population in thousand	25,631	26,349	27,032	27,708	28,398	29,105
Population growth rate		2.72	2.53	2.44	2.43	2.43
Employment to population ratio, 15+, in %	44	45	45	45	44	45
Total labor force, 15+ in thousand	11,380	11,778	12,029	12,468	12,608	13,098
Public sector employees ^a	426	466	515	559	670	740
Public sector employees as % of total employees	3.86	4.07	4.39	4.60	5.45	5.79

Source: SESRIC, (2013), a) Ministry of Finance, Budget, (2007, 2009, and 2011).

Employment has remained constant since 2006; most of the jobs created by aid money last on average six months.¹²¹ Jobs created by aid agencies in the year 2010 were around 410,000; equivalent to 205,000 annual jobs.¹²²

Public sector employees of the government are highly correlated with the domestic revenues of the government, their correlation is 0.98. Reduction in aid will also indirectly affect domestic revenues such income taxes, custom duties and etc. The correlation between Real GDP per capita growth and domestic revenues is 0.34.

Tab. 17: Correlation between Real GDP per Capita Growth, Domestic Revenues and Government Employees

	Real GDP per capita growth	Domestic revenues	Government employee
Real GDP per capita growth	1.00	0.43	0.34
Domestic Revenues	0.43	1.00	0.98
Government Employee	0.34	0.98	1.00

Source: Authors' estimation, Compiled from World Bank, WBDI, (2013), Ministry of Finance, (2012), and Budget, (2007, 2009, 2011).

The following paragraph describes absorption capacity followed by main factors affecting it.

¹²¹ Peace Dividend Trust (2011), p. 14.

¹²² World Bank. (2013), p. 62.

4.2.3 *Lack of Absorption Capacity*

The three decades of war destroyed the human and institutional capacity of Afghanistan. During the war period no effective investments on higher education, and research and development occurred. In 2002, the ministries lacked basic materials such as stationery and furniture. The lack of capacity is one of the major challenges and limitations faced by the government in holding the ownership of aid. Without effective capacity of its institutions, the government is unable to effectively manage aid. The problem of the lack of capacity is felt throughout the country at all levels from districts to provinces, and from provinces to the capital Kabul. Poor planning and prioritization of projects by ministries, unrealistic cost and expenditure projections, delayed procurement processes, poor monitoring, gaps and overlaps within the task of government institutions are the main reasons for the low absorption capacity of the government.¹²³ Following are some of the major problems leading to the lack of absorption capacity.

4.2.3.1 *Insecurity and Corruption*

High corruption has led to a lack of donor confidence in state institutions.¹²⁴ Insecurity and corruption have led to a lack of accountability, control and management between provinces and ministries to effectively plan and execute the budget. Because of insecurity the duration of project implementation has become unreliable, thus making it difficult for the government to plan its annual budget. Qualified laborers (national and international) are key resources to the government; insecurity threatens qualified laborers, which discourages them to work in an insecure environment. The cost of qualified laborers in an insecure environment is much higher than in a secure environment. The lack of qualified personnel imposes essential challenges to the effective absorption capacity of Afghanistan. Corruption and insecurity have also negatively affected the private sector in Afghanistan.¹²⁵ The lack of competition in the private sector has limited the number of firms bidding on government contracts. Because of the lack of competition in the private sector, the costs of projects have increased two to three times.¹²⁶ Most of the budget of the government is allocated to security sector, thus restraining the `discretionary` resources of the government to invest in its capacity expansion. The elements of the vicious circle (insecurity and corruption) exercise considerable influence on the low capacity of the government.

4.2.3.2 *Crowding Out of Qualified Personnel*

Highly qualified Afghans are often employed by international organizations and NGOs. International organizations and NGOs have a brain drain effect for the government.¹²⁷

¹²³ Ministry of Finance, Budget (2005), pp. 5-6.

¹²⁴ OECD, Budget Execution (2011), p. 12.

¹²⁵ Peace Dividend Trust (2011), p. 20.

¹²⁶ Totakhail (2011), p. 11.

¹²⁷ Ghani (2009), p. 100.

Especially since the number of NGOs exceeds 1,550 in Afghanistan.¹²⁸ International organizations and NGOs pay higher salaries than the government and hence end up employing most of the more qualified personnel. This leads to two problems for the government. On the one hand it undermines the absorption capacity of the government. On the other hands donors claim about the lack of professional staff in ministries, this negatively impacts their on-budget aid allocation.

4.2.3.3 *Lack of Coordination between Donors*

The coordination among the high number of donors and the government makes it difficult to efficiently execute the budget.¹²⁹ The differences between donors' financial systems and the variety of aid delivery mechanisms pose a major challenge for state institutions. State organizations are often confronted with different monitoring, reporting and accountability procedures of donors. Unexpected-unavailability of the multi-trust funds, differences between the requirements of the donors and the government and the deficiency of data on donor annual pledges and disbursements undermine budget planning.¹³⁰ The lack of long term exact commitments of donors hinders the government from adopting long-term, fixed-costs intensive structural investments.¹³¹

4.3 Shock Caused by Withdrawal of Troops

The withdrawal of foreign troops significantly influences employment. Foreign troops do not consume domestic products, even basic aliments are supplied by international supply firms.¹³² In the year 2009 a policy of Afghan First was initiated. The policy was initiated by commander of US forces General McChrystal in mid-2009, which aimed at buying domestic products so that money circles in the country. The policy was reaffirmed by US ambassador Eikenberry and new army commander General Petraeus in July 2010. The policy has been so far a success, about 6,000 people have been employed in nine Afghan companies. One company manufactures boots, five companies manufacture uniforms, and three women-owned companies manufacture organizational clothing and individual equipment items. Lack of quality control and low domestic technological capacities are the major constrains on the implementation of this policy. A joint venture between an Austrian and an Afghan company was signed on 29, December 2010, to make and test transformers certified to European standards in Kabul starting in March 2011. Data on construction costs of military bases is not available, which limits to estimate the impact

¹²⁸ ICNL (2010), p. 1.

¹²⁹ OECD, Budget Execution. (2011), p. 12.

¹³⁰ Development Cooperation Report (2012), p. 2.

¹³¹ Civil Military Fusion Center (2012), p. 2.

¹³² Guardian (2009), <http://www.theguardian.com/world/2009/nov/13/us-trucks-security-taliban>.

on construction sector. Some reports suggest that the US spent, on average, about one billion on the construction of military bases.¹³³

International forces employ local laborers for a number of services, for example the US army relies extensively upon contractors/employees¹³⁴ to support military operations in Afghanistan.¹³⁵ As of March 2011, US Army had (46,389) Afghan, (20,413) American and (23,537) third country citizens as contract personnel in Afghanistan. Afghan contractors made up 51 percent of total contract personal in Afghanistan, equal to 46 percent of total uniformed US Army workforce (99,800).¹³⁶ Contractors perform a wide range of services, mainly base support services, such as maintaining ground, running dining facilities, and performing laundry services. Other major services include security provision, translation/interpretation, transportation and logistics maintenance. The data for contract personal by type of service for Iraq is provided but —exception to security contractors— not for Afghanistan. Nevertheless, the types of services provided by contractors in Afghanistan are similar to those conducted in Iraq.¹³⁷ Figures (19) shows the percentage of employees by the type of services provided in Iraq.

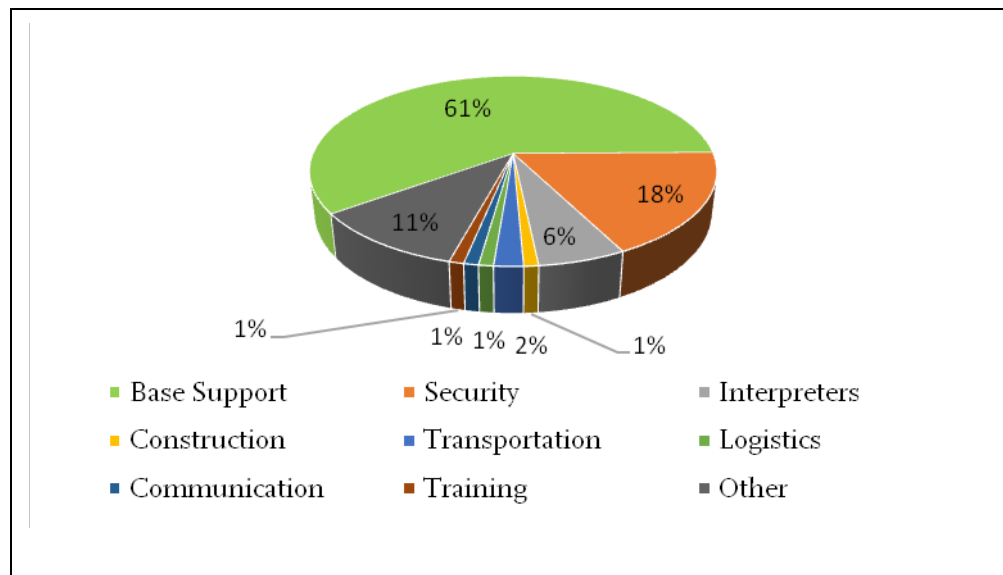


Fig. 19: Contractors by Type of Services in Iraq
Source: Schwartz et al., (2011).

Most of the afghan contractors deliver non-base support services i.e. security, translation, logistics, construction, and transport.¹³⁸ As mentioned for Afghanistan only the data on

¹³³ Washington Post (2009) http://articles.washingtonpost.com/2009-10-18/world/36881791_L_afghanistan-bagram-air-base-troops

¹³⁴ US Army refers to employees as contractors.

¹³⁵ The data on the number of contractors is quarterly data, the number of contractors did not very much in the year 2011 Schwartz, Moshe. Swain, Joyprada. (2011), p. 1.

¹³⁶ Schwartz, et al. (2013), p. 24 and Schwartz (2011), p. 7.

¹³⁷ Schwartz, et al. (2011), p. 10.

¹³⁸ Ibid. p. 5.

security contractors is provided, which as of March 2011, equals to (17,989) Afghan, (250) American and (732) third country citizens. To find, if the given ratio of services by contractor person of Iraq holds for Afghanistan, the total number of security contractors (18,971) is divided by the total number of contractors (90,339). The ratio of security to total contractors in Afghanistan equals 21 percent, compared to 18 percent in Iraq. With acceptance of a margin of error, based on the above comparison, the service to contractor ratio of Iraq is a good approximation for that of Afghanistan.

The total number of non-US foreign troops as of March 2011, equaled to 42,000.¹³⁹ There is no data available about the local contractors with them. The main non-US foreign troop contributing nations include Canada (2,900), Germany (4,909) and the UK (9,000), there are also among the top aid donors to Afghanistan.¹⁴⁰ The number of afghan employees with the German army is around 2,000.¹⁴¹ The afghan employees make up around 41 percent of the German Army workforce. The number of afghan employees working as translators for the UK Army is around 1,200.¹⁴² Translators alone make around 13 percent of UK Army workforce. From the above facts, the ratio of 46 percent of local contractors—similar to that for the US army—seems to be applicable for the above three countries. The ratio of 0.46 multiplied by the sum number of the troops of mentioned countries (16,809) equals 7,732 contractors. For the rest of ISAF nations with total troops of 25,190 a local contractor ratio of (23 percent)¹⁴³ is assumed. The ratio of 0.23 multiplied by their number of troops (25,190) equals 5,790 contractors. Thus the total number of afghan contractors with foreign troops equals to about 60,000. Considering a margin of error (upper and lower bound) of 5 and 10 percent the total number of Afghans employed directly and indirectly with international forces falls in the range of 57,000-63,000 or 54,000-66,000.

¹³⁹ Livingston and O'Hanlon (2011), p. 5

¹⁴⁰ Ibid. and Ministry of Finance (2012), p. 48.

¹⁴¹ Tagesschau (2012) <http://www.tagesschau.de/ausland/afghanistan-deutschland100.html> and http://www.t-online.de/nachrichten/deutschland/id_57076208/afghanistan-bundeswehr-will-einheimische-mitarbeiter-mit-zuruecknehmen.html.

¹⁴² BBC (2013) <http://www.bbc.co.uk/news/uk-politics-22771238>.

¹⁴³ The assumption is based on the fact, that the average annual aid (security and ODA) of these countries from 2002 2011 was less than 60 million. Ministry of Finance. (2012), p. 48.

Tab. 18: Estimated Afghan Employees by Type of Service with Foreign Troops

Service type	% Share of each service in Iraq	Percentage share of each service in relation to total afghan contractor share	Number of contractors in each services
Security	0.18	0.39	23,267
Translators	0.06	0.12	70,56
Construction	0	0.02	11,76
Transport	0.02	0.04	23,52
Logistic	0.01	0.02	11,76
Base and etc.	0.73	0.42	25,200

Source: Author's estimation.

According to the above estimation the withdrawal of foreign troops will have a substantial impact on the employees who provide security and translation services.

4.4 The Shock Caused by Expectation

Investment decisions are based on positive expectations about their future rate of return. The profitability of licit investments are particularly dependent on secure business environment. Insecurity and uncertainty about the future disrupts investment decisions and lead to capital outflow.

The withdrawal of most of the foreign troops after the year 2014 poses essential challenges for the security situation in Afghanistan. Negative expectations about the security, based on the withdrawal of foreign troops, have dramatic negative effects on licit¹⁴⁴ investments in the country.

According to the Chief Executive Officer of the Afghan Chamber of Commerce *“The announcement that foreign forces are to withdraw from Afghanistan has had a negative impact on the economy, investors and traders are concerned about security and political stability after the withdrawal”*¹⁴⁵

For an estimation of the downturn in the economy in the last two years 2011/2012 the annual growth of house prices in Kabul can be considered.

¹⁴⁴ The term licit Investment is explicitly used because of the fact, that a considerable amount of GCF are illicit investments.

¹⁴⁵ Juneauempire (2011), <http://juneauempire.com/opinion/2011-08-28/afghans-alarmed-economic-impact-troop-withdrawal#.UhiXIxtT5XU>.

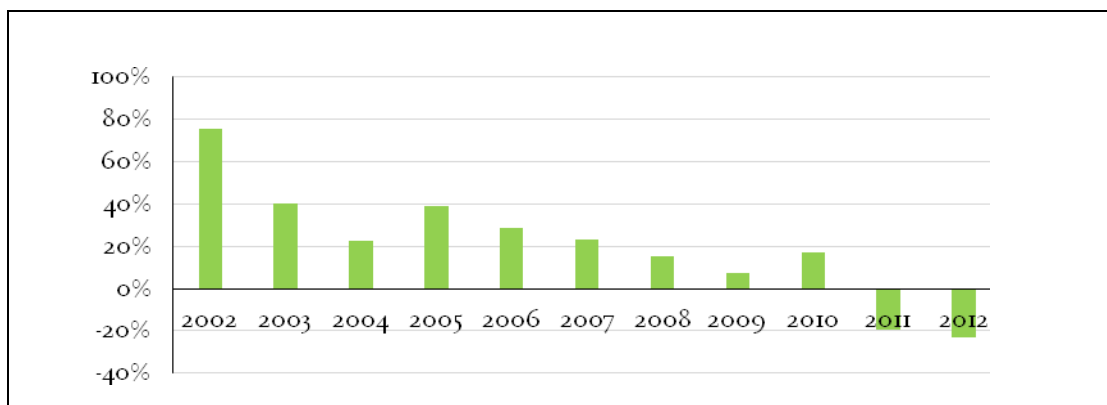


Fig. 20: Annual Growth of House Prices in Kabul

Source: Author's Field Research.

The house prices show negative annual growth, -19 and -23 percent in the years 2011 and 2012 respectively. It seems that the withdrawal announcement possibly has an influence on the downturn of economy; however, a conclusive decision cannot be made on above facts, that solely the withdrawal announcement has caused the downturn in economy. In a question of the questionnaire¹⁴⁶ the respondents of the survey were asked about the withdrawal of foreign troops and the resulting effect on the economy, their results are shown in figure (21).

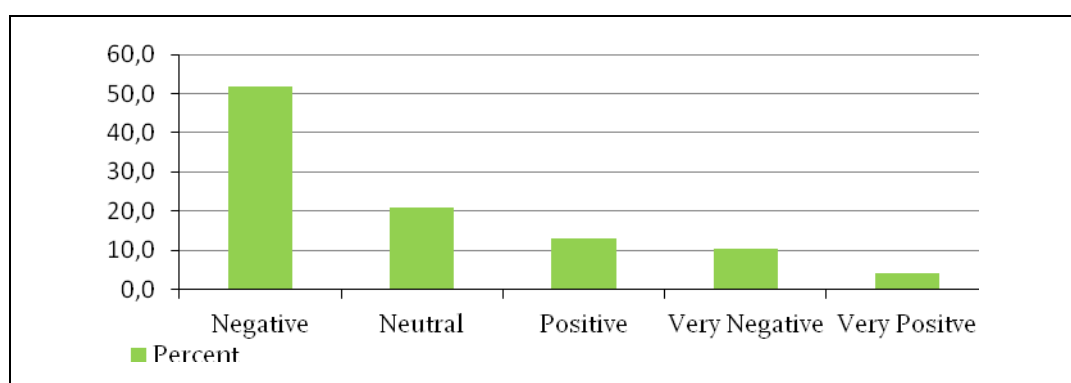


Fig. 21: Effects of Withdrawal of Foreign Troops on Economy

Source: Author's Field Research.

About 62 percent of the respondents of the survey believed, that the withdrawal of foreign troops will have negative impacts on the economy. This seems logical as the main task of foreign troops in Afghanistan is the provision of security; consequently most of the people are concerned about the security after their withdrawal.

In another question¹⁴⁷ respondents of the survey were asked to mention the main factors causing the downturn of the economy in the last years. The respondents mentioned inse-

¹⁴⁶ This data source and etc. for figure (21) come from the conducted survey of households in five major provinces of Afghanistan. For further details about source of data and the survey see the second paper.

¹⁴⁷ See table (17) of second paper.

curity, corruption, withdrawal announcement of foreign troops and fear of reduction in international assistance as the main factors for the downturn in economy. According to above results, negative expectations of people about the future are dramatically influencing and have influenced the downturn of economy.

5 CONCLUSION

The objective of the study was to examine the economic shock resulting from a reduction in international aid as well as the troop withdrawals from Afghanistan. The study investigated the impacts of the reduction in ODA and security aid on real GDP per capita growth of Afghanistan and the direct effects of reduction in aid on the government's budget, as well as the impact of the withdrawal of international troops on employment. Furthermore, the determinants of aid to Afghanistan and other SCACs were analyzed. The effects of ODA and security aid on GDP per capita growth were analyzed with the neo-classical growth model of Solow. OLS regression was used to estimate the parameters of the model. To analyze the determinants of aid to Afghanistan and other SCACs the SUR method was used. The considered variables were derived from previous empirical literature and new variables were included to predict the flow of development aid. For the evaluation of perception and expectations of the people about the aid flows and withdrawal of foreign troops the data came from a country wide survey of household representatives in the main provinces of Afghanistan, which were statistically evaluated.

The results of the growth model state that ODA is significantly influential on GDP per capita growth of Afghanistan, especially when compared to security aid. The coefficient of ODA to GDP is 0.66 compared to 0.28 of security aid. It predicts that any reduction in ODA will have significant negative affect on GDP per capita growth of Afghanistan. The high coefficient of ODA in comparison to security aid is most probably because of two reasons: 1) ODA has high DSR of 32 compared to 18 of security aid, 2) in comparison to security aid; ODA is allocated to sectors that generate economic growth. Only 14 percent of security aid is allocated to productive sectors, such as infrastructure, the rest covers operational and training costs. The results show that the impact of GCF on GDP per capita growth is negative, which is probably because of the high share of illicit investments in GCF. The correlation between GCF and net export value of opiates is 0.95, their share in GDP is 35 and 29 percent respectively. Drug money contributes significantly to insecurity, corruption and weakening of the state, which negatively affects economic growth. Since 2002 a vicious circle has emerged which has evolved to a prevalent constrain on effectiveness of aid, economic growth and development of the country.

The estimates of the SUR method revealed, that the most significant determinant of ODA per capita to considered SCACs is deployment of NATO troops. From the result, it can be predicted that the flow of aid will decrease with the withdrawal of troops. The model prediction is in line with the ground facts of Afghanistan. Compared to 2011 the number of foreign troops decreased in the year 2012 by about 29 percent; correspondingly the amount of ODA pledges for the years 2012-2016 have decreased about 42 percent. The results of the model show, the high level of violence is negatively related to the allocation of aid to considered SCACs. The estimate shows that all of SCACs have not profited from the high flows of aid to fragile states in the new millennium.

Though the share of donor grants to core budget has decreased from 68 percent in 2005 to 50 percent in the year 2011, wages accounted for above than 56 percent of core budget expenditure in the year 2011, in the same year donor grants covered 50 percent of core

budget expenditure.¹⁴⁸ Any reduction in operation grants will have severe consequences for public sector employees, who make about 6 percent of the total employed labor force of the country. Domestic revenues cover only 59 percent of the operation expenditure, which are essential for the maintenance of government's structure. Reduction in grants to the operation budget will have dramatic consequences for the structure, legitimacy of the state as well as the security of the country. About 57 percent of the operation budget is allocated to security sectors. Up to a 55 percent reduction in the development budget has no effect on economy, because the government has executed, on average, only 45 percent of its development budget. The main constraints on budget execution are the lack of qualified personnel, increasing insurgency, high corruption, large number of donors with different financial systems and aid delivery mechanisms which require different monitoring, reporting and accountability procedures.

The withdrawal of foreign troops will affect about 54,000-66,000 employees, depending upon their withdrawal schedule. The number of known employees by type of service include 23,000 security personnel, 7,000 interpreters and about 3,500 logistic and transport personnel.

The pattern of aid allocation to Afghanistan (ODA and security aid) revealed the lack of a post-conflict economic reconstruction plan, Afghanistan received considerably less ODA per capita than Bosnia Herzegovina and Iraq in the first eight years after conflict. The overall ODA per capita in the eight PCYs to Afghanistan was only 60 and 43 percent of that allocated to Bosnia Herzegovina and Iraq respectively, though the GNI of the country was only 15 and 24 Percent of that of Bosnia Herzegovina and Iraq, and its CSR was 3.4 and 20 times higher respectively. Though, ODA increased in later years, the insufficiency of resources and the inclusion of corrupt elements in the government hindered the development of the country. The considerable efforts of many donor countries are highly appreciable who have delivered their sincere assistance to the country, due to their assistance for the first time since 1978, the country achieved significant economic growth which has positively affected the HDI in the country, but it will probably not lead to the long term objectives of sustainable economic growth in the presence of the vicious circle. The first and foremost precondition for a successful PCER and development is the war to peace/security transition, which has not taken place since 2001. Due to the lack of a successful security transition, the vicious circle emerged which has had dramatic effects on the DSR of aid, absorption capacity, effectiveness of aid, legitimacy of the state, economic growth and development of the country. By the mutual consideration of the results of growth regression and the survey, a fundamental question of FA is addressed i.e. has aid contributed to poverty reduction or has it flown to corrupt channels. Economists consider GDP growth as an indicator for economic and social wellbeing of a nation because of its high positive correlation and causal relationship with other development indicators. This consideration is true for countries with stable social, economic and political conditions, but probably not for fragile states as Afghanistan. The low contribution of aid to economic development is shown in the constant high unemployment ratio.

¹⁴⁸ Ministry of Finance, Budget (2013). p. 21.

Limitations of the study

The lack of reliable and efficient data sources concerning major economic and social indicators in Afghanistan restricted this study to estimate the exact effect of reduction of FA and withdrawal of international troops on employment, investment and wages. Moreover, due to the budget and time limitations the field survey was conducted only in five major provinces. This study recommends future researches to extend the field survey across the country, particularly to the rural areas, to see the difference in expectations and perceptions of the public across rural and urban areas regarding the withdrawal of foreign troops and the flow of aid.

Recommendations

To alleviate the economic shock caused by withdrawal of troops and reduction in development and security aid following recommendations shall be considered.

- First and foremost actual ground facts (corruption, insecurity, lawlessness and illicit economy) should be addressed, which have significant negative effects on effectiveness of aid, economic growth, development and Domestic Spending Ratio. A Marshall Plan for the illicit economy and rule of law is required.
- An Organization should be founded to oversee the efficiency and effectiveness of security aid, since the security sector has been the largest recipient of FA, but still the security condition is severe.
- Government should take effective measures against corruption; this would increase the DSR and encourage more funds from donors. Combating corruption will increase the FDI in the country that will counterbalance the reduction of aid and the resulted negative impacts on the economy.
- Long term commitment of aid should be ensured, which should be based on large scale employment, intensive infrastructural projects and well-defined development goals, instead of merely troops presence.
- The International Community and the Afghan Government should establish long term cooperation agreements concerning the economy, security and rule of law in order to ensure the safety of people as well as that of their investments and gain their confidence to invest in the country, which will stop the capital flight.
- To increase the Domestic Spending Ratio of foreign aid, partnerships among Afghan and international firms should be founded in order to enable Afghanistan to produce industrial and sophisticated goods.

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ANNEXES

I: Questionnaire Real estate Property Dealers

My name is Jawid Ahmad Nasery, I am student at the Economics Faculty of Ruhr-University-Bochum, Germany. This questionnaire is a part of my master thesis, which has the purpose to analyze and quantify the impact of current transition (the withdrawal of foreign troops and the modification of foreign aid) on Afghanistan's economy.

Your kind assistance in filling this questionnaire will contribute to the development of constructive and practical suggestions for the afghan government and international community to establish and enforce policies to alleviate the economic shock.

Serial No:_____

Date_____ Name of Property Dealer_____

Please write in the following cells the average growth rate of house prices in Kabul.

No	Year	Average annual house price growth rates
1	2002	
2	2003	
3	2004	
4	2005	
5	2006	
6	2007	
7	2008	
8	2009	
9	2010	
10	2011	
11	2012	

Thank you very much for your participation!

Signature_____

Annex 2: Total Bilateral and Multilateral Aid Commitments and Disbursements as of December 2011 (\$ Million)

Rank	Donor	2002-2011 Commitment	2002-2011 Disbursement
1	United States of America	57,383	47,524
2	Japan	3,821	3,821
3	European Union/European Commission	3,077	2,816
4	United Kingdom	2,574	2,578
5	Germany	2,435	978
6	Asian Development Bank	2,400	1,129
7	World Bank	2,378	1,852
8	India	1,588	759
9	Canada	1,371	1,371
10	Netherlands	1,109	1,110
11	Australia	953	806
12	Norway	852	712
13	Sweden	736	736
14	Italy	697	589
15	Denmark	503	503
16	United Nations	446	182
17	Iran	399	367
18	France	376	199
19	Turkey	226	193
20	Spain	220	194
21	Finland	178	178
22	United Arab Emirates	169	151
23	.Russian Fed	151	147
24	Agha Khan Development Network	140	140
25	Saudi Arabia	140	103
26	China	139	58
27	Switzerland	138	120
28	South Korea	116	83
29	Czech Republic	111	105
30	Islamic Development Bank	77	24
31	Belgium	61	57
32	New Zealand	40	40
33	Poland	30	28
34	Ireland	22	21
35	Kuwait	19	19
36	Luxembourg	12	11
37	Hungary	6	5
38	Lithuania	5	5
39	Austria	5	5
40	Pakistan	5	0
41	Brunei	4	0
42	Greece	2	1
43	Singapore	2	2
44	Estonia	1	1
45	Portugal	1	0
Total		85,116	69,723

Source: Ministry Of Finance, (2012).

Annex 3: Total Number of International Troops as of December 2011

	Albania	286		Germany	5,000		Poland	2,580
	Armenia	126		Greece	153		Portugal	140
	Australia	1,550		Hungary	415		Romania	1,873
	Austria	3		Iceland	4		Singapore	39
	Azerbaijan	94		Ireland	7		Slovakia	309
	Belgium	520		Italy	3,952		Slovenia	77
	Bosnia & Herzegovina	55		Jordan	0		Spain	1,526
	Bulgaria	597		Republic of Korea	350		Sweden	500
	Canada*	529		Latvia	174		The former Yugoslav Republic of Macedonia**	163
	Croatia	317		Lithuania	236		Tonga	55
	Czech Republic	623		Luxembourg	11		Turkey	1,840
	Denmark	750		Malaysia	46		Ukraine	23
	El Salvador	24		Mongolia	114		United Arab Emirates	35
	Estonia	159		Montenegro	39		United Kingdom	9,500
	Finland	156		Netherlands	183		United States	90,000
	France	3,932		New Zealand	188			
	Georgia	937		Norway	429		Total	130,638

Source: Livingston, O'Hanlon, (2011).