CIVIL-MILITARY FUSION CENTRE
AFGHANISTAN IN TRANSITION
January 2012
Comprehensive Information on Complex Crises

The Impact of Corruption on Investment

Part 5 of a 6-Part Series on Corruption & Anti-Corruption Issues in Afghanistan

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*This report comprises part five of a six-week series addressing corruption and anti-corruption efforts in Afghanistan. This piece reviews the relationship between corruption and investment, particularly foreign direct investment (FDI), in Afghanistan. Related information is available at www.cimicweb.org. **Hyperlinks to source material are highlighted in blue and underlined in the text.***

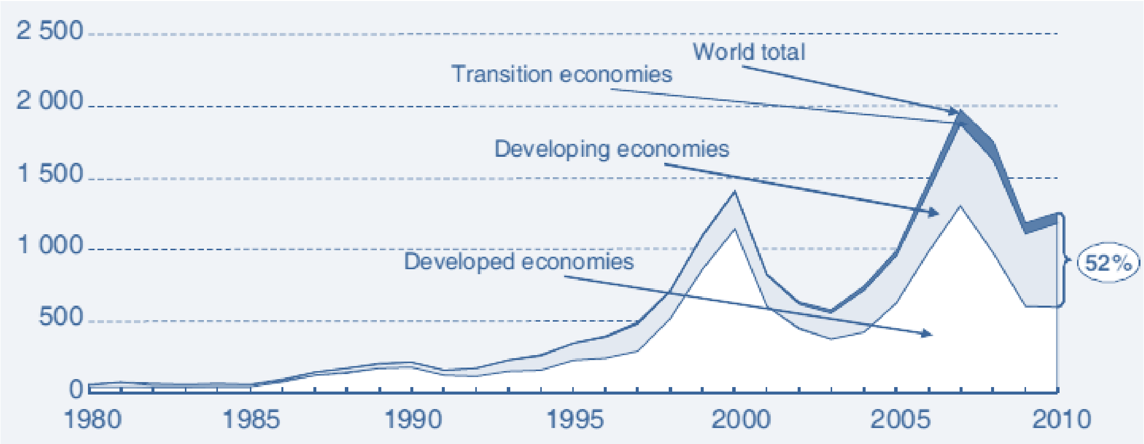
Foreign Direct Investment (FDI), according to the Organisation for Economic Cooperation and Development (OECD), is defined as the following: "a category of investment that reflects the objective of establishing a lasting interest by a resident enterprise in one economy (direct investor) in an enterprise (direct investment enterprise) that is resident in an economy other than that of the direct investor." More simply stated, FDI involves an individual or enterprise from one country investing in the economy of another country. This report highlights the benefits of FDI for developing and conflict-affected countries but also cites research which shows that investors may be deterred by corruption.

FDI is viewed as one of the premier forms of financing for development for a wide range of reasons, according to an article by Prakash Loungani and Assaf Razin in the journal *Finance & Development*. These include the fact that FDI does not only comprise financial resources but also frequently includes the transfer of new technologies and capacities (skills) to the recipient nation. In addition, unlike development assistance or other forms of foreign aid, FDI creates substantial tax revenues for the recipient nation's government. The journal *Central Asia* further notes that FDI has been associated with increases in productivity, employment creation and the transfer of managerial and technical skills as well as innovative production techniques. Foreign direct investors are reportedly interested in long-term investments in the productive sectors of host states, according to an article by Padma Mallampally and Karl P. Sauvant in *Finance & Development*. Other resource flows to developing countries, including loans and grants, may be provided according to short timelines which rarely apply to FDI. Finally, a foundational article by Barry P. Bosworth and Susan M. Collins, entitled "Capital Flows to Developing

Economies", indicates that FDI spurs domestic investment in businesses at a ratio of one-to-one, thus serving as a catalyst for additional investment and growth. Taken in sum, research suggests that FDI is a crucial source of financing in order to enable developing countries such as Afghanistan to alleviate poverty and generate jobs.

FDI inflows to developing countries around the world rose from USD 481 billion in 1998 to USD 636 billion in 2006, according to *Economy Watch*. While the global financial crisis of 2008 led to a sharp decline in FDI, it increased sharply, up 12% to USD 574 billion, between 2009 and 2010. In addition, a sub-set of developing countries, those identified as "transitioning" from conflict to peace, also reflect impressive growth in the course of the past decade. These trends are reflected in Figure 1 (*below*), which notes that the majority of FDI (52%) in 2010 went to developing and transitioning economies rather than developed countries.

Figure 1. FDI Inflows by Economic Grouping, 1980-2010 (USD Billion)



Source: UNCTAD, World Investment Report 2011

Factors Encouraging & Discouraging FDI

There are many policies and factors determining the decisions of potential foreign investors, particularly corruption. The OECD provides an extensive list of policies and factors which not only affect the potential foreign investors but which also influence established foreign investors (those who have already invested in a developing economy) and the responses of domestic firms. Table 1 (*next page*) presents a selection of the most significant factors affecting new foreign investors.

One of the most significant of these factors is corruption. An article published by the Cato Institute, a public policy think tank, highlights a complex relationship between corruption and FDI inflows. In addition to presenting a financial and legal risk for would-be investors, corruption also has an adverse effect on many other factors that investors consider. These include the recent level of investment, public investment, infrastructure quality, healthcare, education and income inequality.[1] The same article also notes that bribes paid by the foreign investors for obtaining licenses or government permits decrease the expected profitability of investment. Moreover, because corruption agreements are not enforceable in the courts of law – and because the forms and extent of bribery cannot necessarily be predicted – corruption increases uncertainty and risk for would-be investors.

[1] These points build upon many of those made in the Civil-Military Fusion Centre's (CFC) series on corruption and anti-corruption issues in Afghanistan. For instance, infrastructure quality is likely to be limited if contracts are awarded to firms which are not the most qualified. Similarly, corruption in the education sector may reduce the credibility of secondary school diplomas and university degrees. Such factors, which stem from corruption, would be factored into investors' decision making, notes the Cato Institute.

Table 1. Factors Affecting Inward FDI

Economic policies largely under domestic control		Other Policies and Factors
Industrial Policies	*Macro-economic Policies*	
(1) Efficient administrative procedures and rules on ownership	(1) Availability of Infrastructure and a skilled workforce	(1) Global and regional economic integration and transportation cost
(2) Developing key sectors (agglomeration/clustering)	(2) Privatization opportunities	(2) International, regional and bilateral treaties
(3) Developing export platforms (Export Processing Zones)	(3) No impediments to trade of goods and services	(3) Location
		(4) Absence of corruption

Source: OECD, Government Policies Towards Inward Foreign Direct Investment in Developing Countries

Levels of FDI in Afghanistan

The data on FDI inflows to Afghanistan is difficult to ascertain and not currently available to the public for years beyond 2008. However, the Afghanistan Investment Support Agency (AISA), an Afghan government body tasked with facilitating FDI, provides such data for registered businesses between 2003 and 2008. A downward trend can be observed in AISA FDI data, with the exception of 2006. According to *Radio Free Europe/Radio Liberty*, such a decline comes despite an overall upward trend in FDI for Central Asia during the same time period. AISA further notes that the FDI data should be interpreted with care given that a significant portion of FDI has been provided to contractors and logistics firms which are used by the international civilian and military stakeholders; hence, it is not clear what percentage of the FDI is likely to remain within the country (versus which percentage may be withdrawn as the international community scales down its presence in Afghanistan).

Table 2. Foreign Investment Indicators for Afghanistan, 2004-2008[2]

	2004	2005	2006	2007	2008
Total FDI (USD Millions)	234.81	176.92	409.24	207.36	108.58
Number of foreign companies registered in AISA	249	379	504	193	291

Source: Afghanistan Investment Support Agency, Annual Report 2008

According to AISA's latest annual report from 2008, the total FDI inflows reflected in Table 2 are distributed among the following sectors of the economy: services (39%), construction (34%), agriculture (18%) and industry (9%). In addition, AISA reports that Turkey was the largest source of FDI for Afghanistan, providing 19% of the total. It is followed by the United Arab Emirates (UAE), which provided 17% of FDI to Afghanistan, the United States with 16%, Canada with 16%, Iran with 9%, China with 8% and Pakistan with 7% of the total investment inflows. Of course, it must be acknowledged that these figures are currently out of date by approximately three years and do not reflect post-2008 trends in investment. Recent and sizable investments by China in the Aynak copper mine in Afghanistan, by an American consortium in gold mining in northern Afghanistan and by India in

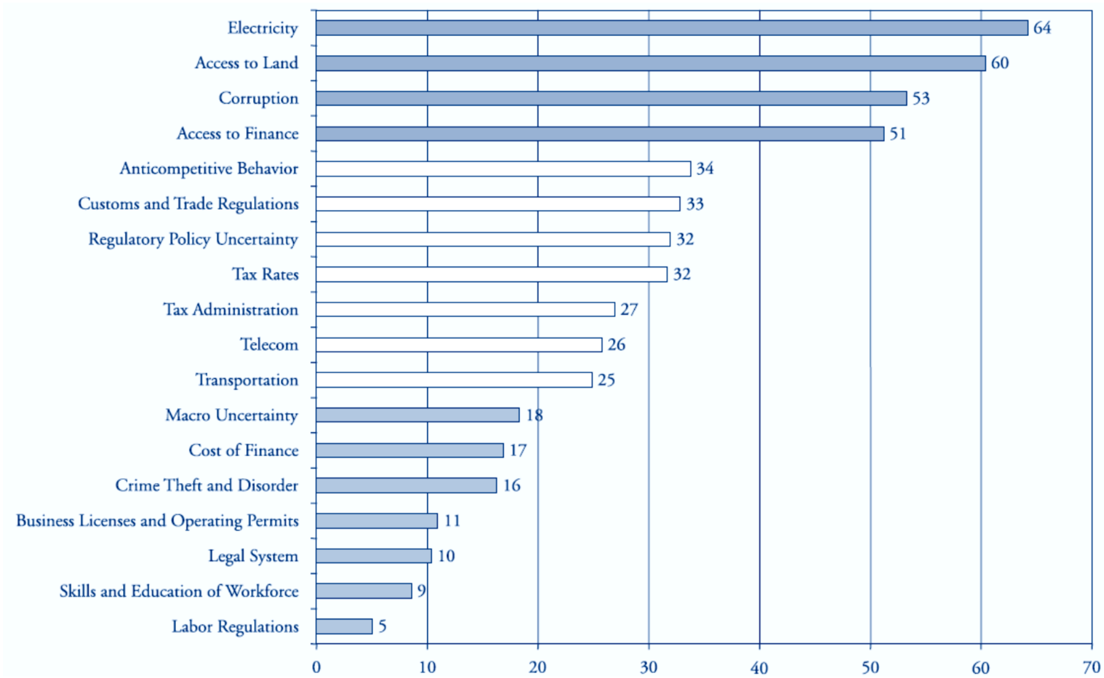
[2] More recent data is not publicly available from AISA.
[3] The deputy, who became Minister of Mines, is the same individual who was later forced to resign amidst accusations that he had accepted bribes in exchange for awarding the rights to the Aynak copper deposit to a Chinese, state-owned firm.

iron ore mining (following the awarding of the Hajigak mining rights in late 2011) are likely to significantly add to these figures.

Investment & Corruption in Afghanistan

As recent Chinese and Indian investments suggest, Afghanistan has the potential to attract investment due to its geostrategic location along the ancient Silk Route and its rich mineral resources, according to *Outlook Afghanistan*. The challenge is thus to identify and promote those factors most likely to enable and facilitate investment. Indeed, Afghanistan appears to have certain regulations which are capable of promoting business development and hence FDI. The World Bank's report *Doing Business 2012: Doing business in a more transparent world*, ranks Afghanistan 30 out of 183 countries for ease of starting a business. Officially speaking, only seven days and four procedures are formally required in order to start a business. However, despite the reported ease of starting a business in Afghanistan, the same report indicates that it is an overall daunting and problematic location in which to invest or operate a business. Afghanistan ranks 160 out of 183 countries on the 2012 Doing Business Index, which reflects a declining position from the 2011 index, when Afghanistan was rated 154 out of 183 countries.

Figure 2. Percentage of Firms in Afghanistan Identifying the Following Constraints as Major or Severe



Source: World Bank, The Investment Climate in Afghanistan, 2005

The World Bank's report on *The Investment Climate in Afghanistan* identifies the major obstacles to investment as the following: electricity, access to land, corruption and access to finance. Corruption was the third most commonly cited factor constraining business despite the fact that the survey conducted by the World Bank (*see the results in Figure 2*) took place in 2005, when corruption was reportedly a much less severe problem across Afghanistan. In 2005, Transparency International's Corruption Perceptions Index (CPI) ranked Afghanistan 117 out of 158 countries surveyed; by 2011, Afghanistan was ranked 180 out of 182 countries. In addition, several of the other obstacles cited by Afghan businesspeople, including access to land, anti-competitive behaviour and tax administration, are closely related to corruption. Land rights, for instance, are often allocated illegally (e.g., based on personal connections and corruption); enforcement of property rights also often hinges on such factors, according to a recent CFC report on "Managing Land in Afghanistan".

In addition to surveys, narrative and case study evidence highlights the negative impact that corruption has had on FDI in Afghanistan. *Reuters* recently reported that foreign investors are deterred by corruption, among other factors. Yu Minghui, a Chinese investor who had hoped to establish a small steel plant and employ 80 Afghans, indicated that relevant authorities are obstructive and constantly seeking bribes. He stated the following about the process: "Even small matters like visa for technicians can be time-consuming, and additional money is sometimes demanded to make the whole process quicker." Bribes are reportedly required not only for establishing a business but also for relevant permits, visas (as noted above), gaining access to the electricity grid and so on. As such, even investors who brave the reports of corruption (in addition to insecurity) and attempt to establish businesses in Afghanistan may still find their efforts thwarted. Reports are less available for another, and likely much larger, class of would-be investors: those who refuse to consider investment in Afghanistan due to the reports of endemic corruption.

One telling example comes from the mining sector, which is increasingly viewed as a driver for Afghanistan's long-term growth, according to the World Bank and others. However, a report by James R. Yeager, a former advisor to Afghanistan's Ministry of Mines (MoM), suggests that corrupt and opaque tender processes surrounding mining rights, which accompanied the awarding of the Aynak copper mine to a Chinese state-owned firm, may mean that highly qualified and reputable investors may be unwilling to bid. Indeed, *Reuters* noted that the world's top mining firms, particularly Rio Tinto and BHP Billiton, have stayed away from Afghanistan's large mineral deposits in recent years despite having been courted by leading Afghan officials.

Bribery is reportedly only one form of corruption which inhibits investments. A 2010 risk assessment by the United States Agency for International Development (USAID) for a natural gas development project in northern Afghanistan also cites "[c]ollusion between [the Afghan government] and business elite for access to capital and commercial opportunities". These tight-knit bonds may make it difficult for foreign firms or investors to gain a foothold in particular markets which are dominated by networks of political and private-sector power-holders. For instance, the *McClatchy News Agency* investigated the privatisation of the formerly government-owned Ghori Cement Factory in Afghanistan. The report indicates that, with the reconstruction of Afghanistan expected to require mass quantities of cement, the factory was considered a crucial economic asset. It was ultimately sold to a firm owned by the brother of Afghan President Hamid Karzai and relatives of other leading Afghan officials. The factory was sold despite the fact that it had not formally been put up for sale and only after the minister of mines, who opposed the sale of the factory to Mahmoud Karzai and his associates, was unexpectedly replaced by his deputy.[3] With the outcomes of major economic decisions being made according to political connections and without heed for technical criteria (e.g., qualifications, past track record, proven availability of capital, etc.), foreign firms and investors may decide against competing and hence investing.

Reducing Corruption, Increasing Investment

The Afghan government and international community have both taken steps, briefly discussed here, in order to counter corruption in hopes of promoting investment. First and foremost among these efforts has been the establishment of AISA in September 2003. The agency describes itself as a "One Stop Shop for Investors" and has responsibility for facilitating the registration, licensing and promotion of all new investments in Afghanistan. By unifying such services within a single agency, AISA not only makes the process faster and easier – it also reduces the opportunities for corruption. Investors independently seeking authorisations, permits and licenses from a range of disparate Afghan government agencies may be more vulnerable to corruption. AISA was formalised as a governmental body through the 2005 Law on Domestic and Foreign Private Investment in Afghanistan. This law aimed to provide a non-discriminatory business environment for both foreign and domestic investors; in order to promote investment; it opened business ownership to non-Afghans. In addition, the law envisioned a High

[3] The deputy, who became Minister of Mines, is the same individual who was later forced to resign amidst accusations that he had accepted bribes in exchange for awarding the rights to the Aynak copper deposit to a Chinese, state-owned firm.

Commission on Investment (HCI) to serve as the Afghan government's focal point for investment policy-making. The HCI, however, does not yet appear to have been established.

A wide range of other initiatives, too many to specify here, have also been taken to promote investment by, either directly or indirectly, combating corruption. These include the Afghanistan Investment Guarantee Facility (AIGF), which was created as part of a partnership between the Asian Development Bank (ADB), the UK Department for International Development (DFID) and the World Bank's Multilateral Investment Guarantee Agency (MIGA), according to *Tolo News*. Established in 2003, AIGF is one of several initiatives to provide political risk insurance to investors, thus reducing the risk they face when investing in Afghanistan due to insecurity and governance deficits. A total of six guarantees have so far been underwritten with the AIGF covering the agricultural, financial, construction and telecommunications sectors.

Conclusion

As this report has noted, FDI is a major driver of development in developing countries and states transitioning out of conflict. Yet corruption poses a major challenge for FDI in Afghanistan. Reducing corruption is crucial for promoting investment, and important efforts are being attempted in pursuit of this objective. Despite this report's focus upon corruption, it must be noted that corruption is far from among the sole obstacle facing investment. Insecurity in many parts of the country is also a crucial factor which, when combined with high rates of bribery, lead to the sort of uncertainty which deters would-be investors. Both reducing corruption and increasing security are required to grow the Afghan economy in the coming years.