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IMPROVING THE INVESTMENT POLICY FOR ATTRACTING FOREIGN DIRECT INVESTMENT INTO AFGHANISTAN

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ACKNOLEDGMENT

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ABSTRACT

Foreign Direct Investment (FDI) is widely accepted as a main source of capital inflows and a vehicle for economic growth in many countries. In fact, the significance of FDI is much higher for developing countries. One of the major economic obstacles for development in developing countries, and also Afghanistan, is the lack of financial capital for investments due to low level of domestic saving.

Taking this into account, this thesis analyzes Afghanistan's current FDI policy and business conditions. It also examines the Afghan investment assessments of two major international organizations: 1) the Enterprises Survey (2014) and 2) Doing Business (2015) both from the Group of World Bank. According to Enterprises Survey Report, political instability, corruption, access to land and access to financing are the major obstacles for investors to enter and expand their business in Afghanistan. According to the Doing Business Report, much needs to be done for providing a friendly business environment for both domestic and foreign companies in Afghanistan. Except the starting business indicator, which has a relatively good ranking, all the other Doing Business indicators require effective reforms. These include dealing with construction permits, registry property, protecting investors, cross border trading, and contracts enforcing policy.

Furthermore, based on the analysis the assessments above, this thesis tests for several investment impacting variables by utilizing linear OLS regression analysis and employing panel data for the period of 2002-2014. This is done to investigate the strong and weak aspects of Afghan investment policy. The results suggest that market size and labor force significantly encourage FDI inflows into Afghanistan. In contrast, political instability, corruption and lack of hard infrastructure are found to have a negative impact on FDI inflow. A positive correlation between FDI inflow, natural resources and trade openness, was originally expected, interestingly, however it is found to be negative. This may be due to the fewer observations in my test.

In sequence, FDI source countries now precisely consider the investment market in term of economic development, political stability, rule of law and particularly investment policy that formalize free environment for foreign investment.

LIST OF ACRONYMS

ACDR	Afghanistan Center for Dispute Resolution
AIGF	Afghanistan Investment Guarantee Facility
AISA	Afghanistan Investment Support Agency
ESCAP	Economic and Social Commission for Asia and the Pacific
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
DB	Doing Business
GoIRA	Government of Islamic Republic Afghanistan
HIC	High Commission on Investment
MIGA	Multilateral Investment Guarantee Agency
OECD	Organization for Economic Co-operation and Development
OLS	Ordinary Least Squares
OPIC	Overseas Private Investment Corporation
PIL	Private Investment Law
PPP	Purchasing Power Parity
SME	Small and Medium-sized Enterprises
TIFA	United States – Afghanistan Trade and Investment Framework Agreement
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

LIST OF TABLES AND FIGURES

CHAPTER 1. INTRODUCTION

Foreign direct investment (FDI) is an essential part of an open and effective international economic system and is a main vehicle for the development and integration of the global economy. Particularly FDI has played an important role in the economic growth of developing countries since the 1990s. FDI, as engine of economic growth, has been subject to much literature discussion by many economic experts and researchers (Borensztein, De Gregorio, & Lee, 1998; Xiaoying, 2005; Denisia, 2010, and others). Most developing countries sought that FDI has a positive impact on domestic investment; other major benefits include that the industries of the host country will gain access to new technologies and international markets, increasing domestic employment opportunities, productivity and management skills, boost technical and professional skills in the host country, enhance economic growth, and improve overall living standards.

The global flows of FDI have been increasing significantly since the 1980s. But global FDI declined by 16 percent in 2014 to 1.23 trillion USD, downward from 1.47 trillion USD in 2013, due to global economic instability in the whole global markets. However, inward FDI into developing countries and transition economies has grown at an extraordinary rate in its history, which comprised 55 percent world FDI flows (UNCTAD, 2015, P. 2). Indeed, developing countries have been experiencing strong economic growth in the past two decades and unparalleled opportunities for foreign investment.

Attracting FDI has become an essential part of development strategy for many developing countries over the past three decades. Most countries welcome and support inward FDI, because they expect that foreign companies will enable local firms to become more technologically advanced. One of the major economic problems of developing countries is the lack of capital to finance their investments. Over the past three decades, developing countries have been taking great steps to open up their protected local markets to foreign investment and international trade. Like many other developing countries, Afghanistan also suffers from a lack of capital to improve its economy. To this end, policymakers have considered various incentives and policies to attract FDI, and to ensure its constancy with the domestic economic development objectives.

The main policy objectives for attracting FDI have been to provide an attractive business environment for the investors, where they will be able to carry out their business activities profitability and without causing unnecessary risk. Experience shows that a number of the most important factors considered by investors as strategic investment policy are as follows: a predictable and non-discriminatory regulatory and a stable microeconomic environment, sufficient and accessible resources, providing numerous tax privilege and incentives, and other legal measures to activate inward FDI flows (OECD, 2003).

According to Blonigen and Wang (2005), those countries that attract significant amounts of FDI flows characteristically implement favorable policies such as, stable macro-economic policies, strong property rights protection, adequate infrastructure, and a clear competitive regulatory environment, which can support domestic investment and improve overall productivity.

To this end, the investment policy theory will be used in my thesis as a basic tool to examine Afghanistan's investment policy. This will help us to understand the domestic, regional and global level of business environment and facilitate policy makers to take effective method to improve the conditions for business.

SECTION 1.1. THESIS STRUCTURE

This MA thesis is consists of six chapters. The first chapter covers the generalities of the research. The second chapter briefly overviews the economic development and the amount of inward investment to Afghanistan for the past decades. Chapter three broadly talk about the current Afghan foreign investment policies and reform. Chapter four analyzes impediments and potential constraints of the Afghan investment policy utilizing surveys and reports from various international financial institutions. Chapter five tries to find out the potential determinants of FDI in Afghanistan. These FDI determinants will contribute to identify the pros and cons of factors that affect FDI flows. Therefore, the analysis result will help to isolate and prioritizing attention investment policy areas, where reforms need to be implemented. Finally, Chapter six summarizes and provides some coherent

policy recommendations for the investment environment in Afghanistan.

SECTION 1.2. RESEARCH AIMS

In this study, I am going to examine Afghanistan's investment policy, why FDI is so important to enhance its competitive business environment? Since 2002, there have been economic improvement, no doubt, in all sectors but those are not significant enough and the Afghan economy has not undergone any major changes. After more than a decade of international engagement, this country is still dependent on international aids and its economy faces the highest level of ambiguity. Therefore, a policy to improving country's economy throughout effective foreign investment is the main objective of the Government of Islamic Republic of Afghanistan (GoIRA). Besides several factors, FDI is one of the key factors that could play an important role in the future economic growth and development of Afghanistan. This study intends to outline efficient ways to promote FDI, to create a conductive policy environment and to enhance the legal framework to ensure the protection of foreign investment.

SECTION 1.3. RESEARCH OBJECTIVE

The purpose of this study is to apply the theory of investment policy, to analyze the current investment climate in Afghanistan, to evaluate the potential determinants of FDI in Afghanistan and to investigate the FDI strategies of foreign companies once they invest in the Afghan market. Furthermore, my aim is to overview the successful international experience of developing countries in protecting and guaranteeing foreign investors' rights.

Taking into consideration that Afghanistan is a landlocked country in term of access to global sea routes, ability to attract FDI into the area is considered relatively weak. However, the abundance of natural and mineral resources, its geographic location and cheap labor force are the main factors that encourage foreign investment to this country compared to other South Asian countries.

There are many empirical studies on FDI in developing countries and particularly for South Asian countries, but however mostly excluding Afghanistan. Most of their results are contradictory.

Numerous scholars examine the determinants of FDI and investment policy for the developing countries in the region (e.g. Azam M & Ling L, 2010; Rahim M, 2006; Rana E & Atif N 2010; Sttarove Kh, 2012).

SECTION 1.4. RESEARCH PROBLEMS

According to Alfaro (2003) most countries and particularly developing countries, consider FDI as a key component for economic development. FDI is generally accounted for as a capital accumulation, technology advancement, marketing and management know-how accumulation. Afghanistan, just like most other developing countries suffer from a shortage of investment both domestic and foreign. Many developing countries are improving investment policies in order to attract foreign investment. Natural and mineral resources, geographical location, and the potential for economic development are some major contributing factors that could attract FDI into Afghanistan. But the level of foreign investment is very low compared to its resources and economic potential. This is suggested to be largely due to its domestic political instability and lack of security.

Afghanistan bears significant FDI opportunities in almost all sectors and particularly in the mineral resource sector, which is GoRIA's the first top priority. According to the current investment policy of Afghanistan, the other top priority sectors to attract investment into are agriculture, construction materials, telecommunication, transports and logistics. In other words, the diversification of inward FDI inflow should be supported. This goal requires a lot of effort and policy implementation.

SECTION 1.5. RESEARCH QUESTIONS

I will attempt to answer the following research questions in my thesis regarding the implementation of Afghanistan's investment policy, FDI pull factors that Afghanistan has in the region due to the abundance of natural and mineral resources, its geographic location, industrial potential and economic development, as well as the international investment climate for businesses.

My research questions are as follow:

- What factors encourage foreign investors to invest into the Afghan market?
- What are the obstacles against FDI inflow to Afghanistan?
- What are the main potential determinants of FDI in Afghanistan?
- What should be done in order to improve the investment policy in Afghanistan?

SECTION 1.6. RESEARCH METHODOLOGY

The collection of data and other relevant information is an important and integral part of writing a research paper; in the given study several research methods will be used, including, descriptive, qualitative and statistical analysis. The main focus of my research is on FDI trends and statistics, utilizing mainly publicly available data from UNCTAD, the World Bank. Moreover, I will examine the current FDI policy environment and strategy of the GoIRA. This analysis helps me to understand and hopefully improve certain concern in relation to FDI policy and regulations in Afghanistan. The hypothesis for my research is about the weakness of the Afghan business environment, the lack of information support and promotion as the most important factors that have a negative impact on the inflow of FDI into Afghanistan. The statistical analysis highlights the investment climate weaknesses and indicates areas of support foreign companies for investment.

SECTION 1.7. DATA SET

The time framework of my thesis covers the recent years' statistics of FDI in Afghanistan 2002 to 2014. The main reason is that FDI inflow to Afghanistan was very low in the 1990s. However, the inward FDI inflow into Afghanistan has constantly increased over the past decade to shape that will be discussed in the next chapter.

CHAPTER 2. INVESTMENT INFLOW INTO AFGHANISTAN

This chapter will mostly investigate the FDI in Afghanistan; its source countries, its distribution by economic sectors, contribution to the economy eventually display the overall FDI flow into South Asian countries. Before beginning the discussion regarding the inward flow of FDI into the country, is important to know how markets and prepares itself for attracting FDI. What are the investment opportunities the host market has on offer and to what extend are these exploitable for foreign investors?

Hence, it appears important to begin this chapter with an introduction to major Afghan macroeconomics indicators, because a stable political environment and strong economic growth provide secured business conditions for both domestic and foreign investment. In the first section, I would like to briefly discuss an overview of the economic development of Afghanistan achieved over the past decade.

SECTION 2.1. OVERVIEW OF AFGHANISTAN'S ECONOMIC DEVELOPMENT

The Afghan economy is recovering from more than three decades of conflict. It has been improving significantly since 2002 due to infusion of international aid, the recuperation of agriculture sector, and growth in the service sector. Afghanistan has moved from a centrally-planned economy towards an open and free market based economy system since 2002. The legal baseline for this was laid with the new Afghan Constitution in 2004. Article 10 of the Afghan Constitution recognizes 'market economy' as the Afghan economic system and guaranteed to encourage and protect private investment. Since that the economy became extremely liberal and the GoIRA places its highest priority private sector growth. From 2003 to 2011, the average growth rate was 11.2 percent. In the past decade in the region only a small number of countries had a growth rate above 10 percent. This is a significant success for Afghanistan despite of serious security challenges exist in the country (AISA, 2012).

According to a report by Indexmundi (2013), in 2011, a net inflow (percentage of GDP) of

FDI was 0.43 in Afghanistan. In the past 41 years the highest value was 4.32 in 2005, however the lowest value was -0.01 in 1977. GDP per capita increased more than threefold between 2002 and 2013, rising from 198.2 USD to 662 USD (Table 1).

TABLE 1. THE MAIN MACROECONOMIC INDICATOR FOR AFGHANISTAN

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
GDP growth (annual %)	…	8.4	1.1	11.2	5.6	13.7	3.6	21.0	8.4	6.1	14.4	1.9	2.0
GDP per capita, (current US$)	192.2	203.7	224.9	257.2	280.2	380.4	384.1	459.0	569.9	622.4	690.8	662.0	659.2
Population, total (million)	21.5	22.6	23.5	24.4	25.2	25.9	26.6	27.3	27.9	28.9	29.8	30.7	31.7
Gross fixed capital formation (% of GDP)	12.3	16.8	18.8	21.6	23.4	19.9	18.9	17.9	17.9	16.6	16.8	17.7	15.8
Inflation, GDP deflator (annual %)	…	11.7	11.2	10.9	7.2	22.4	2.2	-2.1	9.4	10.6	8.3	4.0	4.3

Source: World Bank Development Indicator

Afghanistan is a landlocked mountainous country, geographically located within South Asia and Central Asia and strategically lies in the center of the ancient Silk Route between East and West. With the territory of the 652,000 km^2 (252,000 sq mi), making it the 41st largest country in the world. Afghanistan shares borders with six different countries. It is bordered by Pakistan to the south and east; Iran to the west; Tajikistan, Turkmenistan and Uzbekistan to the north; and China to the far northeast. In 2015 the populations of Afghanistan exceeded 32 million. Afghanistan is also a key transit route for Central Asian oil and gas to major sea ports and markets in South Asia and overseas.

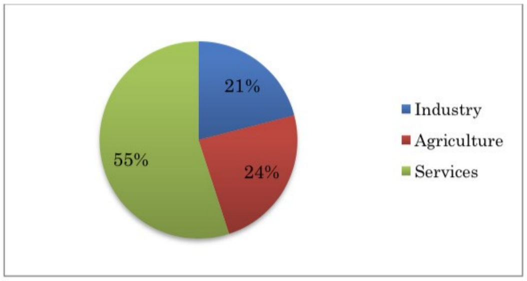
There have been improvements, no doubt, in all sectors but those are not significant enough and much unseized potentials remains. Afghanistan remains one of the poorest countries in the Asia-Pacific region, still the majority of Afghans live in depressing poverty without access to safe drinking water, electricity, housing, education, health and transportation services, lowering its standard to some of the worst in the world. The GoIRA estimates that 42 percent of the country's total population lives below the national poverty line with income of US 14 USD per capita per month. Moreover, food poverty was estimated to be around 45 percent of people who were therefore unable to purchase sufficient food to guarantee the world standard minimum food intake of 2,100 Cal/day (ANDS, 2008-2013).

After more than a decade of international engagement, this country is still dependent on international aids and its economy faces the highest level of ambiguity. Much needs to be done to help Afghanistan achieve its development potential and capitalize on its natural resources and the central geographic location.

The withdrawal of a large number of foreign military troops from Afghanistan in 2014 and declined in assistance of donors' countries had a negative impact on the economy of Afghanistan. In addition to requiring political and security adjustments, Afghanistan has faced and faces a potentially difficult period of economic retrenchment. Economic growth in 2013 was estimated at 3.3 percent having fallen from 11.9 percent in 2012 (ADB, 2014, as cited by ESCAP, 2015). Withdrawal of foreign military troops and increased savings reduce consumption creating significant downwards pressure on growth.

According to the World Bank (2013), sectoral contribution to GDP of Afghanistan 21 percent of value added is by industry, 24 percent by agriculture and 55 percent from services.

FIGURE 1. SECTORAL CONTRIBUTION IN GDP (%)



Source: World Bank, 2013

The role of the private sectors sharply increased since 2002, which provided a great opportunity to small and medium-sized enterprises (SMEs) to enhance the creation of a

market-based economy. GoIRA prioritized the private sector as a key factor for economic growth, which contributes considerably to poverty reduction in the country.

Afghanistan is one of those countries that ironically have a relatively open economy in term of trade and investment compared to other low income countries (LICs) as demonstrated in (Table 2). Afghanistan is determined to push for further trade integration and has joined and wants to join various regional economic organizations. Currently Afghanistan is member of the Central Asia Regional Economic Cooperation (CAREC), Economic Cooperation Organization (ECO), and the South Asian Association for Regional Cooperation (SAARC), and has signed SAARC's Agreement on South Asian Free Trade Area (SAFTA) in 2008.

TABLE 2. DEGREE OF OPENNESS AND TARIFF RATE IN THE REGION

Countries	Openness	Average applied tariff rate	Maximum duty applied	No. of MEN applied tariff lines
Afghanistan	61.7	5.9	50	5,331
India	45.8	13.7	150	11,477
Iran	43.7	26.6	400	6,847
Pakistan	38.1	13.5	100	6,998
Tajikistan	73.1	7.8	292	13,802
Turkmenistan	111.9	…	…	…
Uzbekistan	72.9	15.4	230	10,984

Source: PENN WT (for openness), 2010 and WTO Tariff Profile, 2013

The export of goods which was officially recorded was about 515 million USD for the period of 2013-14. The export of carpet made up 17 percent of the total exports of the country. In 2012-13 exports of carpets compared to 2013-2014 increased from 44.4 million USD to 86.3 million USD. The exports of fresh and dried fruits increased by 24.1 percent in 2013-14 compared to 2012-13. The import of goods which officially recorded was about 8,724 million USD during 2013-14. Pakistan and Iran have been the main regional players in term of cross-border trade. Total imports decreased by 3.8 percent in 2013-14 compared to 2012-13 (from 9069 million USD in 2012-13 to 8,724 million USD in 2013-14). In 2013-2014 imports of food items, spare parts, petroleum, vehicles, machines and equipments, compared to 2012-13 decreased by 1.4 percent. In 2013-14 total trade exchange was 9,239 million USD and share of exports was 5.6 percent imports were 94.4 percent (Statistical Yearbook, 2013-14, p. 217).

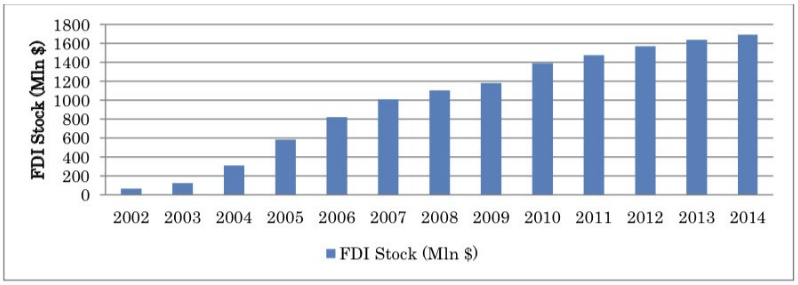
SECTION 2.2. FDI FLOW INTO AFGHANISTAN 2002-2014

Along with the economic growth in different sectors and economic structural progresses in Afghanistan since 2002, FDI has also increased and somehow played an important role for economic growth of the country but much potential remains to be seized. The policy to strengthen the country's economy through effective foreign investment is the main objectives of the GoIRA. For this reason, the GoIRA established the Afghanistan Investment Support Agency (AISA). The main duty of AISA is to promote and attract investment into Afghanistan. It is also responsible to allocate land, provide licenses to companies, and other facilities to both domestic and foreign investors to established their firms and wishing them to invest in Afghanistan. The GoIRA recognized that FDI can play an essential role in the future economic growth and development of Afghanistan.

Afghanistan is one of the countries which have been receiving FDI over the past decade, but the value for this indicator has fluctuated significantly due to the political instability. FDI inflow to Afghanistan for the period of 2002 – 2014 was shown in (Figure 3) the FDI inflows to Afghanistan increased from 2002 – 2005 and the highest value of FDI inflow was in 2005 about 271 million USD. From 2006 – 2014 shows the fluctuation of FDI inflows and the lowest value of FDI inflow were in 2014 about 53.56 million USD and it is due to the political instability and lack of security in the country.

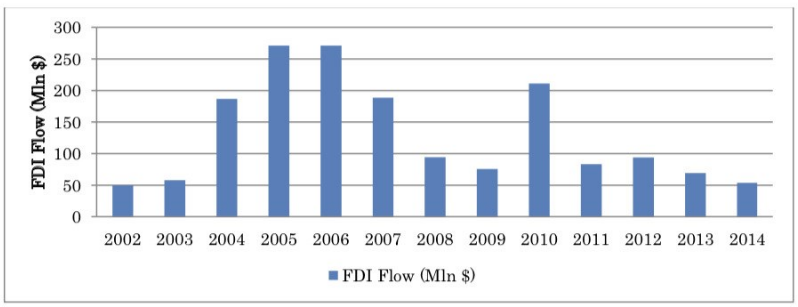
The share of FDI stock in structured of capital investment did not have a significant effect on the structural progress of economy and development of industrial production or an increase in the foreign trade of the country (Figure 2).

FIGURE 2. FDI FLOW (STOCK) INTO AFGHANISTAN



Source: UNCTAD database

FIGURE 3. FDI INFLOW TO AFGHANISTAN



Source: UNCTAD database

SECTION 2.3. FDI COUNTRIES ORIGIN

Afghanistan is remarkably rich in natural and mineral resources. According to AISA (2012) currently there are more than 1,400 deposits that have been identified including energy minerals. A large stock of the strategic resources and agricultural raw materials can play a major role on its economy. Afghanistan is also close to some of the largest and fastest-growing market in the world compare to the other countries in the region. Afghanistan is located strategically between rich energy countries of Central Asia and seaports in South Asia, which provided a key transit route for oil and gas of Central Asian countries to the markets in South Asia and rest of the world. Furthermore, Afghanistan has natural access to the markets of fast-growing markets such as China and India.

The number of countries and corporations investing in Afghanistan has increased since 2002. AISA's statistics show that the total value of FDI is 3.8 billion USD from 2003 – 2015 which makes approximately one third of private investment in Afghanistan.

According to the outcome of 2003 – 2015, the largest FDI source country was United State of America. The Afghan – USA Trade and Investment Framework Agreement (TIFA) serves, as the primary references for bilateral trade and investment in Afghanistan and since its signing in 2004, that the volume of trade between the two partners has increased significantly.

According to the TIFA council meeting (2012), exports from the United States of America to Afghanistan increased by 1,333 percent from 150 million USD in 2004 to 2.2 billion USD in 2010. Imports from Afghanistan to the United States of America increased by 243 percent from 25 million USD in 2004 to 85 million USD in 2010. The TIFA Council in its regular meetings ensures that the development of economic agreement benefiting both sides.

Top investing countries are mentioned in (Table 3) all of which are major trading partners both in exports and imports.

TABLE 3. Top SOURCE COUNTRIES INTO AFGHANISTAN IN TERMS OF TOTAL VALUE OF FDI 2003-2015

No	Countries	Total Value of FDI (million $)
1	United State of America	223.2
2	Turkey	158.9
3	Uzbekistan	138.5
4	Canada	117.6
5	Iran	96.9
6	China	75.5
7	Russian Federation	71.8
8	United Kingdom	58.9
9	Pakistan	57.1
10	Czech Republic	49.2
11	India	34.5
12	Germany	23.2

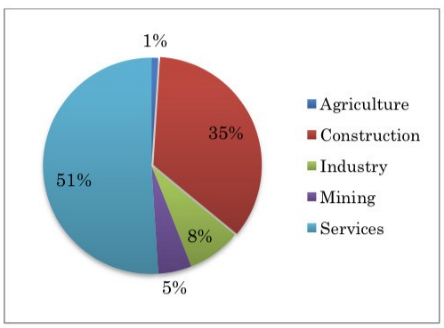
Source: Afghanistan Investment Support Agency (AISA)

SECTION 2.4. SECTORAL DISTRIBUTION OF FDI

The distribution of FDI by sector of the economy has been different in Afghanistan. The sectoral distribution of FDI in various sectors is likely significant to evaluate the long term impact of FDI in the economy of Afghanistan, such as its contribution to the promotion of exports or the creation of new jobs. The investigation of FDI distribution by economic sector suggests that the government favors FDI to specific sectors and second, foreign investors prefer investing into specific sectors.

The figure below illustrates the share of FDI inflow per economic sector. These sectors are: services, construction, mining, industry and agriculture sectors. The service sector attracts the largest amount of FDI with the over 51 percent of total FDI, the second largest amount of FDI flows into the construction sector 35 percent of total FDI, the third receiver sector is industrial 8 percent of total FDI, FDI in the mining sector come forth with 5 percent of total FDI, and finally the agricultural sector received the lowest amount of FDI with only 1 percent of total FDI inflows.

FIGURE 4. FDI DISTRIBUTION BY SECTORS



Source: Afghanistan Investment Support Agency (AISA)

The priority sectors for the GoIRA are mining, agriculture, construction materials, telecommunication, and transport and logistics sectors.

SECTION 2.5. CONTRIBUTION OF FDI TO THE ECONOMY

According to AISA (2012) out of the total private investment in Afghanistan 34.7 percent is foreign investment. The table below shows employment created due to FDI inflow in Afghanistan from 2003-2015.

TABLE. 4 CONTRIBUTION OF FDI TO THE ECONOMY 2003-2015

Sector	No of Companies	Total Investment in million	No of Local Jobs	No of Foreign Jobs
Services	1,689	937.4	53,849	32,487
Construction	800	630.6	36,628	8,473
Industry	227	140.7	5,565	521
Mining	76	96.1	2,294	1,724
Agriculture	30	14.9	715	87
Total	**2,822**	**1,819.7**	**99,051**	**43,292**

Source: Afghanistan Investment Support Agency (AISA)

SECTION 2.6. FDI FLOW TO SOUTH ASIAN COUNTRIES

Like many other developing countries, South Asian countries experienced an increase in FDI flows over the past decade as most developing countries received a greater share of cross-border investment (David and Amir, 2013)[1]. According to the World Investment Report published by UNCTAD (2015), total foreign investment inflows to South Asia in 2014 increased to 41 billion USD. Nevertheless, FDI inflows to South Asia remain the lowest relative to GDP among developing regions. Compared to the other regions, a cross-border investment into South Asia is lower than other regions in the world.

As shown in the (Figure 5), India is one of the countries that attracted the largest amount of FDI in the region. It is accounting for over three quarters of this figure, and FDI flow increased by 22 percent to 34 billion USD. Despite the high total FDI flows, India's inward FDI relative to the size of its economy compared to countries of similar size is very low. While India is the second

[1] South Asia region is consisting of the following countries: Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.

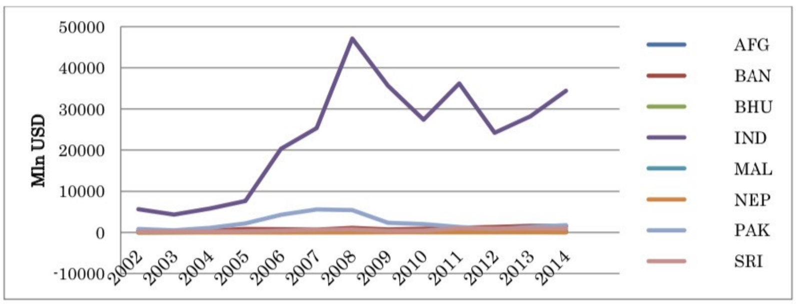
largest developing economy in term of total Purchasing Power Parity (PPP) GDP, according to the World Investment Report by UNCTAD (2011), it was the eighth largest FDI recipient among developing countries in 2010. Among developing countries, China is the largest economy in terms of PPP GDP and the largest recipient of FDI.

In South Asian countries, FDI flows as a share of GDP vary significantly. These differences are geographically, development levels, availability of basic infrastructure, size of their economy, and the legal framework on FDI. Maldives is the smallest economy of the region, but rank highest in term of FDI inflows as a share of GDP at about 5 percent. Pakistan, India and Afghanistan follow in the ranking. Bangladesh, Bhutan, and Sri Lanka are less than the average for South Asian. Nepal attracted the smallest amount FDI as a share of GDP.

The inflows of FDI, including portfolio capital, move with the global business cycle. During the recent global crisis, FDI declined in almost all the countries of South Asia – some more than others. Pakistan is one of the country in the region, which was most affected by the global crisis. It experienced an 83 percent decline in FDI flows during 2007-11 as a share of GDP (Figure 6). After the crisis in 2008, both India and Pakistan experienced a significant reduction in the flows of FDI. FDI inflow to India decreased to 44 percent between 2008 and 2010 and Pakistan was even more affected. Annual FDI into the Pakistan's economy declined to 63 percent in the same period and continued to decrease in 2012. The falling was mainly due to the weakening of Pakistan's macroeconomic environment, along with security problems and political ambiguity.

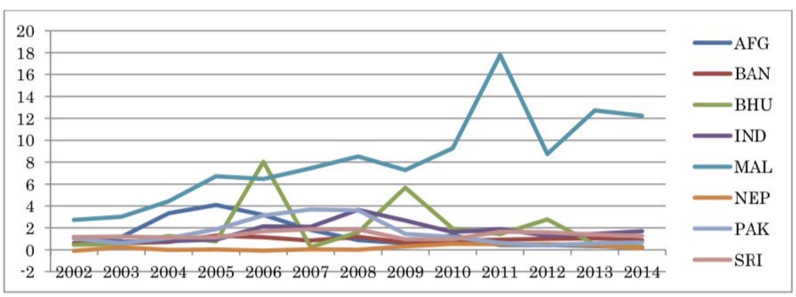
Most countries in the region are witnessing a gentle recovery in foreign FDI flows after the global crisis. In 2009, while the FDI in Maldives was 17 percent under its 2008 level, it has since more than recovered and is above pre-crisis levels. In Bangladesh, the financial crisis caused a 20 percent drop in inward FDI, but in 2011 it rebounded and in 2012 sign point to further recovery. In some countries, FDI trends tend to be less correlated to the global business cycle, but can be subject to large discrete investments, such as mining projects in Afghanistan. Both Bhutan and Nepal have relatively low levels of FDI, and what they receive is linked to India's large public sector investment. FDI in Bhutan has averaged annually about 15 million USD since 2009. FDI in Nepal has gradually increased from 1 million USD as recently as 2008 to over 95 million USD in 2011. Maldives attracted the largest share of FDI in GDP, due to the small size of its economy and the large flows of FDI in the tourism sector.

FIGURE 5. FDI INFLOW TO SOUTH ASIA



Source: UNCTAD database

FIGURE 6. FID INFLOW TO SOUTH ASIA (as percent of GDP)



Source: UNCTAD database

A significant share of FDI flows is concentrated towards the service sector in South Asia, while investment in other sectors such as agriculture, manufacturing, and mining are much smaller[2].

[2] The service sector consisting of: finance; business activities; transport, storage and communication; wholesale and retail trade; Water, electricity and gas; education; health and social services; hotels and restaurants; construction; public administration and defense; social and personal services; and other services.

CHAPTER 3. AFGHANISTAN'S INVESTMENT POLICY

In this chapter, I will broadly discuss the current investment policy and business conditions in Afghanistan. The objective of the investment policy is to mobilize both domestic and foreign investment to assists economic growth and sustainable development, to contribute to poverty reduction, and to boost economic welfare.

Decisions of foreign firms to invest broad are strongly connected with the investment policy condition of the prospect host countries. One of the best factors that attract foreign investment is a favorable investment policy. The most effective investment policies provide better opportunities to foreign firms to conduct their business successfully and give an advantage to achieve efficiency and productivity in the implementation of investment projects. Unlike, poor investment policy increases restrictions and barriers to the inflow of foreign investment.

Investment policy depends on the country's legislation (laws and regulations) to provide rights and guarantees for the foreign investors and secures their investments. According to the Article 10 of the Afghan Constitution, the government is the main guarantor to protect and ensure security of foreign investments. The investment policy of Afghanistan mainly relies on Private Investment Law (PIL). Other important related legislative bases to favor FDI include: the Companies Law, Partnership Law, Consumer Protection Law, Competition Law, Mediation Law, Arbitration Law, and Patent Law.

SECTION 3.1. OPENNESS AND RESTRICTIONS TO FOREIGN INVESTMENT

The GoIRA always welcomes FDI into Afghanistan. After the establishment of a National Unity Government of Afghanistan, the Afghan president M. Ashraf Ghani spoke out clearly the need to attract inward investment. The GoIRA provides and assures the right of foreign investors in Afghanistan. Foreign investors and investment are protected from the violation of any illegal treatment against them. The legal regime completely secures and protects the rights of foreign investors.

According to PIL (2005), the definition of investment is, as currency and contributions in kind, including, without limitation, licenses, leases, machinery, equipment, and industrial or intellectual property rights, paid or provide for the purposes of acquiring share of stocks or other ownership interest in and approved enterprises. The PIL allowed investors to invest in almost in all economic sectors with the exception for example, nuclear power, casinos and production of narcotics and other intoxicants. Article 16 of the PIL specifies that both domestic and foreign investors are provided with equal treatment.

The High Commission on Investment (HCI) is the highest governmental authority for making investment policy in the country[3]. The High Economic Council, which president chairs it, also plays an important role in the development of investment policy and it is consist of, HCI ministers and representatives from the private sectors and academia. The investment, which is more than 3 billion USD, must be approved by the HCI. The HCI also has the power to restrict the share of foreign investment shares in some specific economic sectors and industries.

The form of enterprises could be: enterprises organized under the Afghan law, or enterprises organized under the foreign law, but registered and approved to do business in Afghanistan according to Afghan law. The form of enterprises shall be 100 percent foreign owned entity and also joint ownership with GoIRA and other private investors. There is no need for foreign entities to secure Afghan partners, according to Article 41 of Afghan Constitution, foreign individual are not allowed to own land in the country. In practice most foreign companies decided to start working with an Afghan partner some argue that the lack of land ownership is one of the important obstacles to foreign investment in the country. According to the Article 21 of the PIL, foreign investor can lease land for business purposes, for up to 50 years. Some leases have been negotiated with an automatic renewal clause for the term of up to 99 years.

The GoIRA guarantees repatriation of profits or reinvest them to other entities. Foreign

[3] The High Commission on Investment is composed of: the minister of commerce, the minister of finance, the minister of foreign affairs, the minister of economy, the minister of mines and industries, the minister of agriculture, the governor of central bank, and the chief executer of the office as nonvoting member and as the secretary, it is chaired by the minister of commerce.

investors can open a bank account in local and foreign currencies and conduct all transactions in national and foreign currencies. To start a business, foreign firms are not required depositing any amount of money in the bank.

Any foreign investor who wants to have business in Afghanistan is legally required to obtain investment license from the Afghanistan Central Business Registry (ACBR), to register with AISA, and to get the Tax Identification Number (TIN). To sum up, bureaucratic hurdles to engage in business action in Afghanistan is minimized and the GoIRA continue to try its best to facilitate the foreign business start up climate.

SECTION 3.2. CONVERSATION & TRANSFER POLICY

There is no limitation on converting, remitting and transferring funds related with investment, the foreign investors have the right to freely transfer the capital and profits in any currency out of Afghanistan, at the current present market rate in any times after all taxes payment are executed under the Income Tax Law. According to the PIL, foreign investors can freely transfer investment dividends and proceeds from the sale of foreign firms out of the country.

SECTION 3.3. EXPROPRIATION AND COMPENSATION

According to the PIL, The GoIRA can expropriate an investment or asset only for the purposes of public interest and on a non-discriminatory basis." It further stipulates that the GoIRA should provide prompt, adequate and effective compensation in conformity with the principle of international law, equivalent to the fair market value." If in cases that the investment is made in foreign currency, the law requires compensation to be made in the same currency as well. The GoIRA can also confiscate private property in order to settle bad commercial debts.

Under the Article 29 of PIL, if the foreign investor's share in the ownership of a business is more than 25 percent, the foreign investor has the right to freely transfer any payment as compensation for expropriation without paying taxes out of the Afghanistan, unless the law provide otherwise. Both the Afghan constitution and the PIL prohibit foreigners from owning real estate.

Expropriation of foreign assets has not been reported by government, "creeping" or otherwise.

SECTION 3.4. DISPUTE SETTLEMENT AND ARBITRATION

In order to create favorable investment climate, having a clear and efficient legal system to back it up is essential. The Afghanistan's legal system is consists of Islamic, statutory and customary rules. The supreme law is the Afghan Constitution. The judiciary system is composed of the Primary Court, the Court of Appeal and the Supreme Court. NGOs have been working since 2002, to strengthen the rule of law in Afghanistan by identifying peaceful means for dispute settlements, developing cooperation between government and society actors in the hopes for improving access to justice.

Any disputes, directly or indirectly associated with foreign investment on Afghan territory are settling with mutual discussion of contracting parties. If the parties are not able to reach a mutual resolution, they have the right to apply for the Commercial Court of Afghanistan or Arbitration. According to PIL and the Commercial Arbitration Law: 1) Parties can agree to accept foreign contract law and agree that their disputes resolve through arbitration or other mechanism inside or outside of Afghanistan, and 2) Afghan courts should implement any resulting award or agreement.

Contract law is set out in the Afghanistan Civil Code of 1977 and the Afghanistan Commercial Code of 1955. According to the above codes the parties have the right to: 1) Enter into and carry out a contract at any business subject matter provided that the issue or performance is not contrary to law, public policy or *sharia*[4]. 2) Agree to have the law of a foreign state govern their contract.

Afghan law has explicitly recognized alternative dispute resolution provisions since 2005. The Afghanistan Center for Dispute Resolution (ACDR) was funded by the support of Commercial Law Development Program (CLDP) and USAID in October 2014[5]. The ACDR presents mediation

[4] *Sharia* is an Arabic word. *Sharia* law is the body of Islamic law. The term means "way" or "path", it is the legal framework within the public and some private aspects of life are regulated for those living in a legal system based on Islam.
[5] Established in 1992, CLDP is a division of the U.S Department of Commerce that helps achieves U.S

and expert witness services in a limited number of cases referred by the Commercial Court in future plans to expand its services to include arbitration.

Afghan law has also explicitly recognized mechanism of alternative dispute resolution since 2005. Afghanistan signed the Convention on the Recognition and Enforcement of Foreign Arbitral Award (New York Convention 1958) in 2005. According to this convention, Afghanistan is in agreement to: 1) apply the convention to commercial disputes, and 2) recognize and enforce awards made in another contracted country. Afghanistan has also been a member of the International Center for the Settlement of Investment Disputes (ICSID convention) since 1966.

SECTION 3.5. FOREIGN INVESTMENT INSURANCE

The insurance sector is still at infancy stage in Afghanistan. According to AISA (2015), in mid-2006 an Insurance Commission was established, which issues and deals with licensing procedure for both domestic and foreign investors. Up to June 2014, four companies had received their licenses[6].

The foreign investments insurance from political risk and other threats are protected on agreement basis by insurance companies. Foreign investors have the right to protect their investment in existing insurance companies in Afghanistan. Investment insurance political risk and other possible risk could be protected by international organizations and other foreign insurance companies.

The Afghanistan Investment Guarantee Facility (AIGF) is designed to help bridge the gap between the demands of investors to top business opportunities in the country and concerns about political risks. The facility, operated by MIGA will ease key risks for foreign investors by offering political risk guarantees for their investments.

AISA represents the insurance products of the MIGA, a section of the World Bank. Through

foreign policy goals in developing and post-conflict countries through commercial legal reforms.

[6] 1) Afghan National Insurance Company, 2) Insurance Cooperation of Afghanistan, 3) Insurance Group of Afghanistan, 4) Afghan Global Insurance.

MIGA you can insure your investment against: expropriation, war and civil disturbance, breach of contract and transfer restrictions. The Overseas Private Investment Corporation (OPIC) offers political risk insurance for U.S. companies interested to invest in Afghanistan. OPIC may insure against three types of political risk: inconvertibility, expropriation, and political violence.

SECTION 3.6. INVESTMENT INCENTIVE POLICY

According to the Afghanistan Chamber of Commerce and Industries (ACCI) in 2013 the GoIRA released an Investment Incentive Policy, which sought to channel FDI into five key sectors (agriculture, mining, exports, construction and industry). This policy provides extraordinary privileges for investors who will invest or extend their businesses activities during the transition and transformation decade. Unfortunately, this incentive policy expired in March 2015.

SECTION 3.7. PROTECTING PROPERTY RIGHTS

Protecting property rights is difficult due to the lack of license showing ownership of real property or a comprehensive system of land titling, incapability of commercial courts, and broad corruption in the country. The land laws of Afghanistan are silent about the details of effective land management. Generally, the attorneys and judges are not experts in land matter and thus lack know-how to make adequate decisions. About 80 percent of the land is held and transferred informally, without legal recognized deeds, title, or the simple tool to prove ownership.

At the moment, the gaining of a clear land title to registered leasehold interest is complicated, bureaucratic and burdensome. Disputes of investment are generally in the areas of contracts and land titling. There are many documents regarding the land ownership that have not yet been archived in any official registry. Regularly, several owners claim the same piece of land, each one of them declaring rights from a different source. The mentioned disputes slow down the development of agriculture and commercial businesses. Foreign investors are looking to work with Afghan citizens to purchase property need to complete due diligence to identify dependable partners.

The office for intellectual property at the Ministry of Commerce and Industries is in charge

of issuing patents, industrial designs, trademarks, geographical indications, and genetic resources. The office for Copyrights at the Ministry of Information and Culture is responsible for copyrights and other related rights. The GoIRA is working to approve new rules regarding patents, trademarks, and copyrights aligned in accordance to the World Trade Organization (WTO) standards.

Theoretically, the right of intellectual property holders is protected to through the civil court system of Afghanistan. Courts have the authority to obtain evidence from all parties. The factual findings present a final decision and order the payment of damages and court costs. However, there is no solemn implementation of intellectual property rights yet. A first step was taken by the GoIRA when it joined World Intellectual Property Organization (WIPO) in 2005.

SECTION 3.8. COOPERATION WITH OTHER INTERNATIONAL INVESTMENT & TRADE ORGANIZATIONS

According to the U.S Department of State (2015), Afghanistan signed 31 bilateral investment and trade agreements and in addition 10 bilateral economic agreements with different countries throughout the world. These agreements provide different economic advantages for all the participating countries. Major agreements include the Trade and Investment Framework (TIFA), which was signed between Afghanistan and United States in 2004, the South Asian Free Trade Area (SAFTA), which was signed among SAARC[7] countries in 2008, and the Afghanistan – Pakistan Transit Trade Agreement, which was signed in 2010.

Afghanistan recently also signed the Turkmenistan – Afghanistan – Pakistan – India Pipeline (TAPI), which is a natural gas pipeline project developed by Asian Development Bank (ADB). This pipeline will transport Caspian Sea natural gas from Turkmenistan through Afghanistan into Pakistan and then to India. The construction of the project started in Turkmenistan on December 2015 and the pipeline is expected to be operational by 2019.

On December 2015 at the 10th ministerial conference of World Trade Organization (WTO) in

[7] The South Asian Association for Regional Cooperation (SAARC), is an economic and geopolitical organization which located in South Asia. Member countries are Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.

Kenya, Afghanistan officially became a WTO member. Afghanistan membership negotiations took over 11 years, making it the 164th WTO member and 36 Least Developed Country (LDC) to join the WTO. Accession to the WTO is hoped to encourage Afghanistan's integration into the global economy. Afghanistan hopes for an increasing trade flows, higher domestic job creation, and the possibility to import goods at lower prices. Joining the WTO is expected to create new business allows Afghans to import goods at a lower price. Joining WTO will create new business opportunities for Afghanistan and boost economic growth.

Afghanistan vigorously begun to crate legal framework to protect foreign investors' rights over past one decade. Also Afghanistan has taken concrete steps to create more friendly business environment for foreign investment. In general, the current investment environment is not perfect. Along with the standards and challenges, Afghanistan has yet to fully establish competitive investment conditions patterns that it can outcompete other countries in the region and the world. In order to meet perceptions of foreign investors and greater competition in this area, new investment policy reforms need to be implemented.

Neither UNCTAD nor the OECD, have conducted an investment policy review in Afghanistan yet. Very few surveys and statistical analysis on investment policy and business environment were published in Afghanistan. The purpose of this study is to identify potential obstacles of Afghanistan and provide practical recommendations to policy makers on how to remove these restrictions, effectively shape attractive business conditions for foreign investment.

CHAPTER 4. DESCRIPTIVE ANALYSIS

This chapter is an important part of my study, as I aimed to analyze the Afghan investment policy. Therefore, I want to overview the surveys and reports, which were conducted by various International Organization, such as Enterprises Survey and Doing Business (DB) from the Group of World Bank.

In my analysis my key focus will be on the aspects of investment environment and regulations which cause impediments to doing business efficiently and productively by foreign investors' concern. The motivation behind these studies is to arrange a cautious investment policy to bridge those impediments.

SECTION 4.1. ASSESSMENT BY ENTERPRISES SURVEY

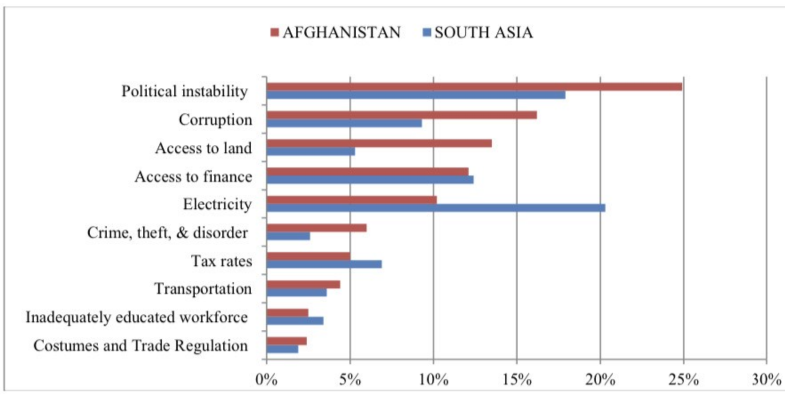
As I mentioned, the investment policy of Afghanistan is overviewed by small number of international institutions. The purpose of this study is to identify the perceptions and preferences of foreign investors and domestic companies while doing business in Afghanistan. As well as, giving them recommendations on technical assistance and promoting data collection and analysis to improve the investment policy for providing friendly business conditions for foreign investors.

The Enterprises Survey is carried out by the World Bank and it covers small, medium, and large companies in Afghanistan. The collected data focuses on the business environment and productivity of foreign firms and performance in Afghanistan. The survey also covers those obstacles that have a negative impact on the activity of foreign firms. The following sectors are included in this survey: manufacturing, the services sector, the construction and transportation sectors but exclude the agriculture sector.

This survey was conducted in 2014. Results were obtained through interviews with the managers and owners of firms and branch offices in Afghanistan. For the data analysis, they used comparable method for Afghanistan in line with the others countries with the same level of income in the South Asia region and Afghanistan income group.

According to the report by Enterprises Survey (2014), there are several business constraints perceived by foreign companies, which were revealed by questionnaire. They stress that political instability, corruption, access to land and others (Figure 7) were the major obstacles for them to expand business.

FIGURE 7. BUSINESS ENVIRONMENT OF AFGHANISTAN BY ENTERPRISES SURVEY



Source: The World Bank, Enterprises Surveys database

As you can see in the above chart, Afghanistan comparing with the other South Asian countries in term of political instability is key factor; it is the top major impediments for FDI inflow into Afghanistan and is the main concern of foreign firms operating in Afghanistan. For example, the prolonged presidential election process of 2014 has negative impact and had led the country to many problems such as political instability, increased insecurity and economic problems.

According to the Afghan Ministry of Finance, "the delay in the announcement of presidential election results has caused revenues to decline by 25 percent". Economic problems faced by the people of Afghanistan are due to the election, before the election the markets were crowded, but after they were empty, people had stopped buying things, the price of goods had increased, land prices had fallen and on the trade and economic activity in Afghanistan had significantly dropped. Since

that, insecurity has increased in almost all provinces, so that few are willing to invest or open new business. Khan Jan Alokozai, a deputy of Afghan Chamber of Commerce and Industries has said to local Medias "because of the political deadlock, the volume of trade has been declined, domestic and foreign investment has decreased, and the flight of capital has begun from the country".

Corruption is the second major impediment for FDI in Afghanistan. According to the Transparence International's 2015 Corruption Perception Index, Afghanistan ranked 166 of 168, after Korea (North) and Somalia; unfortunately it is the third most corrupt country in the world. Corruption by GoIRA officials may lay major financial and administrative burden on companies. Corruption also creates an unfavorable business environment for foreign companies, raising the costs and risks related with DB. For example, one of the recent major corruption cases was the Kabul Bank financial scandal of 2010-13, which were involving those people that have close relationship with high ranking government officials.

Many companies stated in the survey that access to land is the biggest problem for them. The lack of certainty in land tenure is one of the other factors that discourages existing business from making new large investments and effectively impedes new investors, particularly foreign investors, from entering the market.

Access to finance is the key element for business development in a country. According to the survey, lack of financing opportunities is another significant factor that has a negative impact on the productivity of firms. According to the survey, commercial banks in Afghanistan do not provide long-term and large-size loans for companies. So, due to the inaccessibility of long-term loans the firms are not able to expand their businesses or to make new investment.

The next factor is the lack of hard infrastructure, which includes access to electricity, water supply, telephone connections and other communal services. Availability of infrastructure enhances the competitiveness of an economy and creates a favorable business environment for the development of firms and connects companies to their suppliers and customers. The result outcome from the survey, shown in (Figure 7), declares that powers supply is insufficient.

In contrast, the lack of infrastructure generates barriers to productive opportunities and increases production costs for all companies, from micro enterprises to large multinational corporations. Particularly the insufficient supply electricity raises costs, disrupts production and decreases productivity. In order to overcome these obstacles, the related government and non government institutions which are responsible for providing non-stop services should concentrate more on doing their job effectively. This will strengthen the conditions for effectiveness and decreases unpredictable costs.

Crime and informality are the other important factors that impede private sector investment. Crime imposes costs on the companies when they are forced to divert resources from productive uses to cover the cost of security. Crime was perceived as a sign of social instability by both domestic and foreign investors, and crime drives up the cost of DB. Similarly, a large informal sector has serious consequences for the private sector. The informal sector may pose unfair competition for formal firms. These factors are the other serious constraints for both domestic and foreign investors in Afghanistan. Providing security in Afghanistan imposes high costs in all businesses compared to other countries in the region. Security remains a major problem and the cost of insuring security is especially high for foreign companies.

Afghanistan, decisively heading towards a free market economy, must take into account the growing demands in the global market. Explain the boundaries of trade and investment, support of domestic and foreign companies to create favorable conditions for business is necessity of time. Competition in the global market is high so the competitive in all areas of the economy is a top priority for the GoRIA.

SECTION 4.2. ASSESSMENT BY DOING BUSINESS

The investment environment in Afghanistan was also examined by Doing Business (DB) indicators, a co publication of the World Bank and the International Finance Cooperation (IFC). DB reports information on the regulations of business environment of 189 economies around the world.

This important reference data, which measures regulations and ranks the business environment of a country, to find the DB is easy or difficult for both domestic and foreign companies.

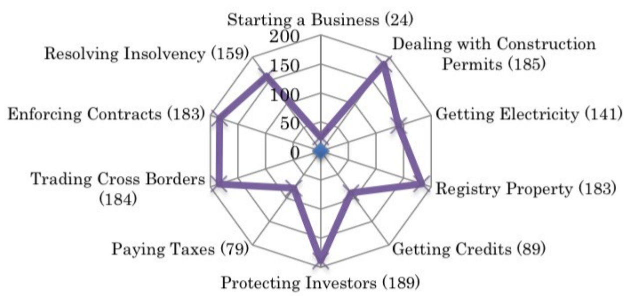
DB analyses the regulatory framework of economies and a long with the estimation indicators such as starting a business, obtaining license for work permission, opening a bank account, obtaining construction permits, getting electricity, paying taxes, accessing dispute settling and property ownership and others.

However, DB does not assess the some other feature, which appears important to the Afghan context, (e.g. market size, security, corruption and macroeconomic stability and others). The DB results do not have an effect on the attractiveness of the examined economies, except any amendments or failure of accomplishment may affect the whole ranking of DB. The DB indicator focuses on the obstacles that companies could encounter during their activities.

However, DB gives practical outcomes on how to adjust the business environment and conditions compared to other economies in the region and the world. DB's ranking method is based on the simple percentile ranking on its factors indicator. The factor indicators differentiate with time; money and number of processes that are need in order to complete business operations.

For example, the figure below shows the whole DB indicators spectrum for Afghanistan compared to the indicators to other countries in the region. The indicators will help us to overview the obstruction of business regulation in Afghanistan.

FIGURE 8. AFGHANISTAN RANKS ON DOING BUSINESS



Source: Doing Business database

All DB indicators as shown in the above (Figure 8) are evaluated by several procedures and cost of documents and time needed to complete the assessment. There is an average estimation for the indicator, which is called a benchmark. This will help us to measure the legislative regime and the connected organizations while companies functioning legal processes.

According to (World Bank DB report, 2015, p. 19), Afghanistan ranked 24th economy among the 189 countries in starting a business indicator in the world. It is due to that in 2014, "Afghanistan made starting a business easier by reducing the time and cost of obtaining business licenses and by eliminating the inspections of the promises newly registered companies". These requirements are the significant factors in the world practice and more open the business environment for foreign investment.

Indicator to obtain construction permits is far from good in comparing with countries in the region. The companies plan to get permission for construction in Afghanistan required to go through 11 legal procedures, spent 323 days and costs 57.4 percent of the warehouse value.

Access to sufficient electricity is an important factor for businesses. In getting electricity Afghanistan ranked 141. Getting electricity needs 5 legal procedures which cost companies 3,373.9 percent income per capita and for all these things to done takes 114 days. Registering property required 9 legal procedures, spent 250 days and pay 5 percent of income per capita. In 2010, Afghanistan made easier the registering property by decreasing property transfer taxes.

On the getting credits indicator, comparing with the countries in the region, Afghanistan is in a good ranking. Afghanistan ranked 89th and it due to that in 2014, "Afghanistan strengthened its secured transactions system by implementing a unified collateral registry" (World Bank DB, 2015, p. 45).

According to the DB, the indicator of foreign investors' protection is very important for the company's ability to raise capital they require to grow, innovation, diversity and competition. In term of protection investor indicator Afghanistan is unfortunately ranked 189 in the ranking of 189. Advance rules and well-functioned court practice could provide strong protection for foreign investors, where foreign investors can secure their interest and ensure fair judicial procedure.

The indicator of paying the taxes and trading across borders are essential for businesses. The low tariff rates and effective tax regulations encourage companies to engage the economic activity correctly; this is why many countries in order to attract foreign investment in some sectors they eliminate tax burdens. About frequency of taxes the indicator of DB for Afghanistan presents, which consists of average 20 payments and spend 275 hours per year for procedure to be done. Afghanistan ranked 79th on the ease of paying taxes among the 189 economies in the world. DB for trading across borders estimates time, cost and necessary documents to complete the transaction. According to DB in trading across borders, globally, Afghanistan ranked 184th, require 10 procedures, 86 days and costs 5,045 USD for imports, and require 10 procedures, 91 days and costs 5,680 USD for exports per container.

Finally, the indicators of enforcing the contracts and resolving insolvency for Afghanistan are not satisfactory comparing with the countries in the region. According to DB, Afghanistan ranked 183rd among the 189 countries in contract enforcement, require 46 procedures, costs 25 percent of the value of the claims and takes 162 days. According to doing DB, in resolving insolvency, globally Afghanistan ranked 159th, takes 2 years, costs 25 percent of the debtor's estate and the average recovery rate is 46.4 percents on the dollars.

To summarize the DB report there is much need to be done for providing friendly business environment for both domestic and foreign companies in Afghanistan. Except the starting business indicator which is in a very good ranking, all the other indicators as I mentioned above require effective reforms to be implemented.

These indicators include reducing the number of procedures and cutting the time required in registering property, getting electricity and dealing with construction permits. Special attention should be given to protection of investors as well by improving the existing legislation that will provide foreign investors more secure and transparent operation.

Furthermore, reduce the number of unnecessary procedures in trading cross border (both export and import operation), enforcing contracts and resolving insolvency indicators. In order to simplify all operational steps required to pass through, fill out the online system should be

implemented that are widely used in world practice.

CHAPTER 5. DETERMINANTS OF FDI IN AFGHANISTAN

The decision of foreign companies to invest in a specific country is strongly associated with those factors that motivate foreign investors to make their investment. These factors might be economic level and industrial growth, natural and mineral resources endowment, availability of infrastructure, legal protection of investment and others. According to the OLI Model which has been developed by J.Dunning a British economist argues that four five of global FDI inflows receive by emerging countries which has the availability of those features (Dunning, 2010).

I widely discussed in previous chapters about the importance and significance of FDI in developing countries. Furthermore, investment policy, attractiveness features and several others factors can play an important role for attracting cross-border investment. In fact, the progression of investment flows across the countries is based on its determining factors of FDI recipient-countries.

The purpose of this chapter is to find out potential determinants of FDI in Afghanistan based on previous theoretical and empirical studies of developing countries. The results will be then tested with the linear OLS regression in order to find out whether these determinants factors are significant for the inward FDI inflow.

SECTION 5.1. LITERATURE REVIEW

Afghanistan hasn't made progress in the field of scientific research, so I did not find any academic paper related to my research topic. Therefore I utilize the papers which have been written on developing countries related to my topic. Determinants of FDI in developing countries and particularly in transition economies have been studied by many researchers, and there have been numerous empirical studies on determinants of FDI.

Many empirical studies in the literature of FDI have identified the following variables as factors that have impact on the flow of FDI, these factors are: GDP per capita, trade openness, natural resources, labor costs, quality of infrastructure, political stability, corruption, domestic macro policies, and etc. However, there is no general agreement in the literature as to direction of influence

of some of these variables.

For instance, Rahim M (2004) examined the determinants of FDI in five countries in South Asia (Bangladesh, India, Nepal, Pakistan and Sri Lanka) employing the panel data from 1995 – 2000 and he obtained the estimated results from a Generalized Lease Square (GLS) regression model. He found that economic freedom, economic openness, economic prosperity, and human capital significantly has positive impact on FDI inflow into the South Asian countries, however political instability has negative impact.

Similar study by Azam and Ling (2010) in their studies on determinants of FDI in India, Indonesia and Pakistan ranging the data from 1971 – 2005 and using the Log linear regression model for each country and the least squares method has been applied and their studies suggest that the main determinants of FDI in these countries are market size, domestic investment, trade openness and physical infrastructure.

The other econometric study was done by Sattrov (2012) he tested the determinants of FDI on two transition economies (Kazakhstan and Uzbekistan) for the period of 1996 – 2010. Using an OLS and Seemingly Unrelated Regression (SUR) and he analyze the major factors that effected FDI inflow to both countries. His results showed that market size, economic stability, and reliability were the significant factors to encourage FDI inflow to these countries. Furthermore, trade openness and infrastructure factors have negative impact on FDI inflow to both countries.

The recent study was done by Qayoom and Irfan (2013) on the determinants of FDI inflow to developing countries. In their work, they used the panel data for the period of 1982 – 2008 and applied the OLS model for the estimation. They sought that market size, total reserves, infrastructure and labor cost factors positively affected FDI inflow to the developing countries. Their finding showed that the factor of openness economy is insignificant.

Generally, the results of earlier empirical studies demonstrate a broad range of FDI in developing countries. Natural resources, market size, low labor cost and the availability of human resources served as important factors for inward FDI. On the contrary, the lack of infrastructure, political stability, corruption, poor regulation and bureaucratic hurdles discourage foreign investors to make their investment in developing countries.

SECTION 5.2. DATA DESCRIPTION

In this section I will attempt to analyze the determinants of FDI on how they impacted inward FDI inflow into Afghanistan. This will help me to identify the strength and weakness side of economy of Afghanistan over other economies in the region competing for attraction of FDI, and also to realize the potential factors of FDI comparing with chapter four in the context of enhancing the investment policy of Afghanistan.

I will test the correlation between FDI inflow and other factors. The purpose is to identify whether an increase in the factors of the country such as natural resources, market size, labor force, trade openness, political stability, corruption and infrastructure facilities will lead to an increase in the flow of FDI. I would like to start by explaining the variables and sources of data.

Natural Resources – Afghanistan is remarkably rich in natural and mineral resources. As I mentioned in the first chapter currently there are more than 1,400 identified mineral deposits. These include energy minerals such as oil, gas and coal as well as iron and copper deposits of the world quality. Furthermore, known precious and semi-precious stones in Afghanistan are: emerald, jade, rubies, alabaster, beryl, lapis lazuli, amethyst, quartz and sapphire. As I discussed in chapter two only 5 percent inward FDI flowed to this sector that were not sufficient, Afghanistan has the potential to attract more FDI in this sector. IMF stylized the wealth of developing country's reserves on natural resources. They present quite a few indicators to line up countries with the estimate based on reduction horizons of extraction and harvesting of natural resources. The indicators comprise the wealth of resources in capital, reserve over the annual production of natural resources, natural resources rents (percentage of GDP) and others. In my equation, natural resource percentage of GDP as a proxy to determine the country's natural resource endowment will be used. The data obtained from the World Development Indicator. I expect that the availability of natural resources in the country will have positive effect on FDI inflow.

Market size – As I mentioned in the previous chapters, market size is one of the most important factor for attraction of foreign investment into developing countries. The value of the size of the market could be interpreted with value of produced goods and services in a country that is GDP. The proxy for market size is GDP in constant a price which is provided by the World Development Indicator. I will use it in my test. As it is widely known, foreign investors are looking for investment potential market in order to obtain high profits. I expect that market size will positively affect inward FDI into Afghanistan.

Labor Force – the other factor that gives confidences to the foreign investor to invest in the developing countries is cheap labor and it is more important in attracting FDI. The rate of unemployment is very high in Afghanistan and the labor cost is very low. The data for this factor is captured from the World Development Indicator as well. Percentage of total labor force used as proxy for cheap labor due to lack of data in Afghanistan. I expected positive correlation between cheap labor and inward FDI inflow into Afghanistan in my test.

Corruption – Corruption constitutes a serious threat to Afghan nation-building and development programs. It has increased dramatically in the country since 2002 due to the weak governance, infusion of international aid and lack of law enforcement on corrupt people. Many studies marked that corruption discouraged foreign investment. As result, corruption decrease the expected profitability of investment and foreign firms lost productivity and raises the concern of foreign investors to invest. Taking into consideration the importance of this factor, I collected the data from World Governance Indicator for this study. I expected negative correlation, because unfortunately Afghanistan is one of the high 5 corrupt countries in the world.

Political Instability – Fast growing economy with a stable political environment is a significant factor for domestic and foreign investors to do business in the country. In view of the fact that stable economic and political conditions provide a safe investment protection from threats related to economic and political risk. Numerous studies marked that political instability decreases domestic investment and prevent foreign investment. For this important factor I obtained data from The Global Economy database. I expect that this factor will have negative effect on inward FDI into Afghanistan.

Trade Openness – This is one of the other important factors that encourage foreign investors to enter to the market. Foreign investors to invest in specific economic firstly planned to export manufactured goods to the country of origin or its neighbors. Effective regulation regarding the trade regime in FDI host countries gives significant advantages to foreign companies to expand their activities. To better understand the efficiency of trade openness in Afghanistan I will utilize trade openness index to my statistical analysis. Sum of export and an import to GDP is considered for this factor. The data obtained from the World Development Indicator. The correlation between this variable and FDI is expected to be positive because higher trade openness will lead to raise the firm's profitability and enhance the confidence of foreign investors.

Infrastructure – Infrastructure is an important factor for economic growth, poverty alleviation and attracting FDI. Infrastructure is reported as a serious problem in many transition countries and it has a negative effect on inward FDI. In fact, countries with inadequate infrastructure are not able to attract technology and provide first need facilities to start function. As a result the countries lose competitiveness among their competitors. Therefore, the availability of appropriate infrastructure can play an essential role in the inflow of FDI. A variable for infrastructure is defined from the fixed telephone lines, mobile phone subscribers and internet access by numerous studies. But I employ as proxy for infrastructure a number of fixed telephone subscriber (percent change per annum) due to the lack of data in Afghanistan. The data acquired from ESCAP statistical database. In my test, I expect a negative correlation between infrastructure and FDI flow.

SECTION 5.3. THE RESULT

The result of linear OLS regression analysis and the relationship between FDI inflow and other factors are presented in (Tables 5). The results suggest that larger market size and labor force boosts the level of FDI inflow into Afghanistan. In contrast, political instability, corruption and lack of hard infrastructure are found to have a negative impact for FDI inflows. A positive correlation between FDI inflow, natural resources and trade openness was originally expected, interestingly however it is found to be negative. This may be due to the fewer observations in my test.

For instance, market size is positively associated with FDI inflow, as expected. This means that the larger the domestic Afghan market size, the larger FDI inflows. Afghanistan, with a population of 32 million, remains one of the largest markets in the region.

Labor force is another significant determinant of FDI and it is also positively correlated with FDI. The country is recognized for the availability of cheap and abundant labor, which attracts foreign investment. So, foreign companies can take benefit of low labor costs by investing in Afghanistan.

Political instability is found to negatively impact FDI inflows. The point estimates show that civil war affects FDI inflow significantly and negatively, especially compared to other countries in the region. Hence, Afghanistan should do its utmost to avoid a politically destabilizing climate and promote stable economic environment that is conductive to long-term planning and investment opportunities, which in turn will attract further FDI.

Corruption and a lack of hard infrastructure also negatively affected FDI flow into Afghanistan. The reason is that high corruption decrease corporate profitability and growth. The lack of hard infrastructures is a significant hurdle to investment and increases production. Especially the provision of electricity, gas, water and others seems to negatively impact on FDI. As a result, there is less initial FDI and already existing firms witness production disruption and productivity decrease.

The natural resources variable, which I expected to positively correlate with FDI inflow, interestingly found negatively impact on FDI. One explanation may be the low number of observations utilized in this test. Therefore, I suggest that a large stock of natural resources and

untapped minerals permit the country to increased depletion of this sector in several times. In theory, natural resources abundance should encourage FDI and domestic economic growth and development. However, currently this figure suggests the opposite. If the government were to turn around the trend it could focus on strengthening the institutions and policy environment to favor the accessibility to domestic natural resources to foreign investors.

The last variable is trade openness, I expected a positive correlation between FDI and trade openness, and however, it is negative. This may be again due to the limited observations in my analysis. I suggest that trade openness to some extent may have a positive effect, but does not appear to be an important factor for FDI in the country.

TABLE 5. REGRESSION RESULT OF OLS MODLE

(Dependent variable: FDI Flow)

VARIABLES	FDI FLOW
Natural Resources	-168.0***
	(27.98)
Market Size	5.80e-08**
	(1.76e-08)
Trade Openness	-5.489**
	(1.682)
Labor Force	245.2**
	(68.28)
Political Stability	-21.41
	(135.4)
Corruption	-62.87**
	(18.66)
Infrastructure	-21.91***
	(5.107)
Constant	-768.2
	(732.4)
Observations	13
R-squared	0.995

Standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

According to the results of this multiple regression analysis, we might assume that Afghanistan has been going towards favoring FDI inflows, and this creating a favorable economic climate for economic growth. However, much remains to be done and the investment policy should be improved. In particularly, the GoIRA has placed emphasis trying to create a better environment for foreign investors in term of transparency of their activities, political stability, and anti-corruption and hard infrastructure development while more efforts need to be dedicated to these areas.

CHAPTER 6. CONCLUSION

The main purpose of my study is improving the investment policy for attracting FDI into Afghanistan. Therefore, I identified the potential factors that discourage foreign investment in Afghanistan. Afghanistan's current investment policy was examined and overviewed the conditions of protecting the rights and guarantees of foreign investors.

I briefly discussed an introduction of FDI inflow into Afghanistan, including FDI source countries, sector distribution, contribution of FDI to the economy and overall FDI inflow to South Asian countries. In order to respond to the perception of foreign investors, I also examined the assessment of two major international organizations: 1) the Enterprises Survey and 2) Doing Business both from the Group of World Bank on the Afghan investment policy.

Furthermore, based on the analysis the assessments above, this thesis tests for several investment impacting variables by utilizing linear OLS regression analysis. This is done to investigate the strong and weak aspects of Afghan investment policy. The results of this test almost proved our expectations. Therefore, to summarize the acquired results persuade that effective measure has been taken to overcome the following problems.

- Lack of investment incentive policy to encourage and support foreign investors in Afghanistan, due to the current business conditions of Afghanistan there is a vast need for incentive packages to provide extraordinary privileges for investors who either will invest or extend their business in Afghanistan.
- Investor's worries and concerns about the future political and economic stability and their investments in the country. This will lead to reduce the consumption and lack of interest of both domestic and foreign investors to invest in the country. To remove worries and concerns of investors regarding political and economic stability the following action are recommended:
    1. Declaring and implementing a clear vision of the GoIRA concerning the macro-economic issues (financial, monetary, industrial, investment and trade

policies).

2. Restoring the confidence of investors on the GoIRA and on the country's future political and economic stability by showcasing the ability of GoIRA to provide security, ensure financial stability and monetary exchange rate, launching major infrastructure and development project, implementation of the law equally on all, and violation of laws and avoiding of land grabbing.

- One of the other major challenges for FDI is corruption in Afghanistan. Reducing corruption is very important for the promotion of investment, and important efforts are being attempted in the pursuit of this goal.
- To provide friendly business environment for both domestic and foreign investors in Afghanistan, administrative barriers associated with local authorities, responsible for registering property, getting electricity and dealing with construction permits to work required effective reforms to be implemented. By easing and eliminating multiple applications including reducing the number of procedures and cutting the time required and decrease of high business costs for both local and foreign firms. Special attention should be given to protection of investors by improving the existing legislation that will provide foreign investors more secure and transparent operation. Furthermore, reduce the number of unnecessary procedures in trading cross border (export and import operation), enforcing contracts and resolving insolvency indicators.
- Increasing the banking operations significantly related with the issuance of credit and loans, timely delivery of cash and foreign exchange. Furthermore, enhancing the registration procedure export and imports contract by reducing the number of documents and make tighter the time for all procedures.
- Lack of inadequate infrastructure and facilities (roads, railways, well equipped ports and industrial parks, electricity, water and etc.). All these need to be provided for all firms and mainly for manufacturing companies to void break up the production. Improve the capacity of related organizations for provision of these services. As Afghanistan is landlocked

country all import and export production are shipped via land. Therefore besides development, overland transportation is also required. To this extend integration of cross-border of overland transportation with other countries in the region is very important.

- Improving the information support of foreign investors about investment policy, protecting of their rights and guarantees in Afghanistan. Foreign companies to be informed broadly on investment opportunities and investment environment should be a key priority for business in Afghanistan. To do this, the Afghanistan investment climate must be promoted and broadcasting over see in well-known economic journals, newspapers and reliable Medias is highly recommended it will raise the confidence of foreign investors to the Afghan market.

Improving the investment policy and providing favorable investment climate for the business allows the country to gain the trust of domestic and foreign companies. The country's reputation will be also increased among the competitor countries and accelerate its integration into the global market. These are the key priority policies to create a strong economic and industrial country.

Afghanistan is heading towards market-based economy; the country must meet the demands of the global market and sustain its economy. This is good preconditions for sustainable economic development for the country. In fact, it is a great competition, but competitiveness is a top priority for Afghanistan in accomplishing its goals.

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